ASIAN DEVELOPMENT

Outlook 2009

Rebalancing Asia's growth

Asian Development Bank

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Foreword

Asian Development Outlook 2009 (*ADO 2009*) is the 21st edition of the annual comprehensive economic report on the developing member economies of the Asian Development Bank.

Part 1 of *ADO 2009* sets out the global economic conditions underlying the assessment of and projections for developing Asia. Part 3 of *ADO 2009* evaluates the recent economic performance of 45 economies in Asia, and provides projections for major macroeconomic indicators for 2009 and 2010.

The effects of the unfolding global economic crisis looms large in the outlook for developing Asia. With limited direct exposure to the subprime assets at the heart of the global financial meltdown, it was thought that the region would be spared the worst effects—an impression that was borne out by the resilience of the region's financial institutions. However, as the financial crisis impinges on global demand, it is clear that avoidance is not an option—crisis mitigation measures must now come to the fore.

Transmission of the crisis through trade channels began in earnest in the final quarter of 2008, slowing growth in developing Asia to 6.3%—a sharp deceleration from the record expansion of 9.5% registered in 2007. Growth in all subregions flagged, except for the Pacific. The People's Republic of China (PRC) and India both grew at a healthy pace, but at slower rates than in previous years. Expansion in the PRC was a robust 9%, while growth in India was estimated to have come in at 7.1%. Growth in most other countries slackened as well.

Inflation intensified during most of last year as global food and commodity prices rallied. Despite the rapid decline in oil prices toward the latter part of 2008, consumer price increases averaged 6.9% for the entire year.

Amid the harsh global environment, prospects for developing Asia are also deteriorating. GDP growth is projected to decline to just 3.4% in 2009. Growth in all subregions is expected to ease further, with East Asian and Southeast Asian expansions slipping by at least 3 percentage points. The newly industrialized economies of Hong Kong, China; Republic of Korea; Singapore; and Taipei,China, will all likely contract in 2009, on account of their heavy dependence on trade to support growth.

As the global economy experiences a mild recovery in 2010, regional growth is projected to improve to 6%. Inflationary pressures will abate on the back of slower economic expansion and falling commodity prices. Consumer price increases are projected to ease to 2.4% in 2009 and 2010.

As turbulence in financial markets and volatility in commodity prices continue, global economic conditions remain unfavorable. There are tremendous downside risks to this global outlook, which could further slash the already dismal prospects. The effectiveness of global responses to the crisis remains uncertain. Loud calls for protectionist policies are becoming worrisome. As job losses in the major industrial countries continue, the protectionist voices may only get louder.

As major industrial countries have already slipped into recession, it is tempting to look with envy at even the slower rate of growth in developing Asia. Such views would be misguided—achieving the region's ambitious poverty reduction goals hinges on the rate at which it can expand employment opportunities and incomes. Under the current outlook, more than 60 million people in the region will remain mired in poverty than would have been if the previous high growth had prevailed.

Fortunately, governments in the region have not remained passive. Fiscal stimulus measures have been undertaken in many countries and many more have announced plans to follow suit. However, there is a dearth of information regarding the form, size, and implementation mechanisms of such fiscal packages. The possible impact of these fiscal packages on regional growth thus remains unclear.

The region's sharp slowdown underlines the risks of excessive dependence on external demand. Rebalancing growth is thus fundamentally in the region's own self-interest. Part 2 of *ADO 2009* explores the issue of rebalancing developing Asia's growth toward domestic sources. Looking ahead, Asian policy makers are facing the key challenge of picking out the optimal mix of policies to strengthen domestic demand in the short- and long-run. Regional countries differ with respect to the magnitude and causes of their dependence on external demand. Therefore, there is no one-size-fits-all optimal policy mix for rebalancing. Nevertheless, in all countries effective rebalancing will require a mix of policies that will both revitalize the domestic economy and bolster domestic demand.

Strengthening domestic demand requires policies that develop social safety nets to encourage more private consumption. Priority should likewise be accorded to enhancing the investment climate and using public investment funds wisely. Policies pertaining to financial development and adjustment of the exchange rate can promote a better balance between supply and demand. In addition to domestic policies, regional and global efforts are required to effectively address global imbalances which are, after all, a global problem with global causes and effects.

HARUHIKO KURODA
President

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Ann Quon, Omana Nair, and Andrew Perrin of the Department of External Relations planned and coordinated the dissemination of *ADO 2009*.

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Definitions

The economies discussed in *Asian Development Outlook 2009* (*ADO 2009*) are classified by major analytic or geographic groupings. For purposes of *ADO 2009*, the following apply:

- **Association of Southeast Asian Nations (ASEAN)** comprises Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam.
- **Developing Asia** refers to the 44 developing member countries of the Asian Development Bank and to Brunei Darussalam, an unclassified regional member.
- **Central Asia** comprises Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.
- **East Asia** comprises People's Republic of China; Hong Kong, China; Republic of Korea; Mongolia; and Taipei,China.
- **South Asia** comprises Islamic Republic of Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.
- **Southeast Asia** comprises Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam.
- **The Pacific** comprises Cook Islands, Fiji Islands, Kiribati, Republic of the Marshall Islands, Federated States of Micronesia, Nauru, Papua New Guinea, Republic of Palau, Samoa, Solomon Islands, Democratic Republic of Timor-Leste, Tonga, Tuvalu, and Vanuatu.
- Unless otherwise specified, the symbol "$" and the word "dollar" refer to US dollars.

ADO 2009 is generally based on data available up to **16 March 2009**.

Acronyms and abbreviations

ADB	Asian Development Bank
ASEAN	Association of Southeast Asian Nations
CPI	consumer price index
EU	European Union
FDI	foreign direct investment
FY	fiscal year
GDP	gross domestic product
IMF	International Monetary Fund
OECD	Organisation for Economic Co-operation and Development
PRC	People's Republic of China
US	United States
VAT	value-added tax
WTO	World Trade Organization

Highlights—*ADO 2009*

Developing Asia's economic growth in 2009 will slow to its most sluggish pace since the 1997–98 Asian financial crisis. The global downturn is having a pronounced impact on the region's exports, and subdued domestic demand will further crimp growth. Inflation pressures will abate on the back of slower economic expansion and falling commodity prices.

A regional recovery will have to wait until 2010 when the world economy bounces back. This outlook, however, continues to be overshadowed by serious downside risks. Further, Asia's large and persistent current account surpluses have contributed to the global imbalances underlying the current crisis, so it is in developing Asia's own self-interest to adopt policies to rebalance its growth.

Key messages

- Deteriorating global prospects have soured the medium-term outlook for developing Asia. Growth began to cool in 2008 from the record levels of 2007. In 2009, growth is projected to drop a further 3 percentage points to 3.4%. The region's growth is projected to rebound to 6.0% as the global economy experiences a mild recovery in 2010.

- The downturn will hit all developing Asia's subregions, substantially slowing the pace of poverty reduction. Governments in the region have acted decisively to fight the downturn through fiscal stimulus packages, but their impact remains uncertain.

- As global commodity prices continue to fall, inflation is expected to ease to 2.4% in 2009 and 2010. Due to a decline in exports and reduced remittances, the region's overall current account surplus is projected to fall to about 4.8% of GDP in the next 2 years. In Part 3 of *Asian Development Outlook 2009* (*ADO 2009*), economic prospects in a country-specific context are examined in more detail.

- The depth and length of the global downturn pose the biggest risk to developing Asia's outlook. Unless crisis-resolution and fiscal stimulus packages are effective, global recovery—and thus the region's recovery—will be delayed. Protectionism presents an especially significant risk to a global recovery, with serious implications for highly trade-dependent developing Asia. Although falling oil prices benefit the region—a major net oil importer—their volatility does not. Slowing growth and rising unemployment could give rise to social instability, which would further damp investment and growth. All in all, the downside risks to the region's outlook far outweigh the upside risks.

- The region's sharp slowdown underlines the risks of excessive dependence on external demand. Part 2 of *ADO 2009* explores the issue of rebalancing Asia's growth toward domestic sources. Effective rebalancing will require a mix of policies that will boost domestic demand and bolster the domestic economy. Specific policy options include transferring more corporate savings to households and strengthening social safety nets; creating a more attractive investment climate by improving institutions as well as social and physical infrastructure; pursuing a more active fiscal policy; and promoting small- and medium-sized enterprises and service industries. Such domestic policies must be matched by a concerted global effort to address global imbalances.

Performance in 2008

- Growth in 2008 fell across developing Asia with only the Pacific performing better than in 2007. Economic expansion decelerated to 6.3% from 9.5% in 2007, which had been the fastest rate in nearly two decades. Regional inflation spiked to 6.9% as global food and oil prices surged in the early part of 2008.

- Expansion in East Asia slowed to 6.6%, from a rapid 10.4% in 2007, as all five economies in this subregion decelerated. Weaker growth in manufactured exports was a major reason. The People's Republic of China (PRC) grew by a robust 9.0%, but the Republic of Korea's growth halved to 2.5% from 5% in 2007. Taipei,China's economy was flat in 2008 following the fourth-quarter fall in electronics exports. Aggregate inflation quickened, but at 5.4% remained the lowest of all the subregions.

- Southeast Asia's growth eased to 4.3%, from 6.4% in 2007. Indonesia maintained growth of above 6% for the first 3 quarters of 2008, before the global slowdown hit manufacturing and exports in the fourth. All the economies in this subregion slowed in 2008, with particularly weak growth in Singapore and Thailand. GDP growth in Viet Nam slowed to 6.2%, after 3 years of 8%-plus expansion. Subregional inflation more than doubled to 8.8%, but has been easing with the slowing demand and declining commodity prices.

- In South Asia, growth moderated to 6.8% from 8.6% in 2007. India's growth slowed during 2008, coming in at an estimated 7.1% for the year, well below the 9% pace of recent years. The global financial turmoil and deteriorating economic outlook caused a major reduction in capital inflows and marked falls in business and consumer confidence. In Pakistan, a large fiscal deficit triggered a balance-of-payments crisis that required stabilization support from the International Monetary Fund. Growth in Bangladesh, Bhutan, Maldives, and Sri Lanka moderated. Afghanistan's expansion was hit by drought, but Nepal rebounded from a slump.

- In Central Asia, growth in 2008 plummeted to 5.7% from 12%, with most countries experiencing a downdraft. Kazakhstan's limited access to global capital markets virtually halted domestic bank lending, cutting growth to only 3.2%.

- Growth in the Pacific strengthened to 5.1%, on the back of high energy prices benefiting resource-rich Papua New Guinea and Timor-Leste, and recoveries in Fiji Islands and Tonga. Inflation shot up last year, to a subregional average of 9.6%, propelled by strong growth of domestic demand in Papua New Guinea and rising global oil prices.

Global outlook

- Turbulence in financial markets and continued weakness evident in recent economic data dominate the global outlook for 2009–2010. GDP in the United States, eurozone, and Japan (G3) in 2009 is projected to contract by 2.6% and world trade volume is seen to decline by 3.5%. A mild recovery is anticipated in late 2010, with G3 growth expected at 1.1%.

- However, downside risks to this outlook are significant, and could further slash already dismal prospects. Ineffective crisis-resolution and fiscal stimulus packages could drag down the current bleak forecasts for the United States and other economies. Emerging protectionism is worrisome. Commodity prices are likely to remain volatile. Deflationary risks are in sight, which could lead to further deterioration of labor markets, yet monetary policy options to combat them will be increasingly limited. Social instability could pose additional threats to economic prospects.

Outlook for developing Asia

- The financial sectors of developing Asia's economies have so far largely weathered the crisis. Bank credit continues to flow normally to the real sector even though access to credit has tightened for riskier borrowers. Limited exposure to subprime assets and improved fundamentals since the 1997–98 Asian financial crisis explain the resilience to the global credit crunch. However, equity prices have tumbled and access to external financing has tightened.

- Apart from the financial channel, Asia has been hit by the global recession through the trade channel. The plunge in G3 income has led to a reduction in its import demand that has resulted in a contraction in developing Asia's exports. This export decline has weakened the region's current account position. Projections indicate that the surplus will decline to 4.9% of GDP in 2009 and to 4.7% in 2010.

- Across the region, factory closures and job losses are rising, weighing on consumer sentiment and forcing households to cut back spending. Slowing demand and the uncertain economic environment are discouraging investment. As business sentiment continues to worsen, capital spending will be restrained.

- Deteriorating global prospects have soured the outlook for developing Asia in the next 2 years. GDP growth is projected to reach only 3.4% in 2009, which is nearly 3 percentage points slower than the 2008 rate. As the global economy experiences a mild recovery in 2010, regional growth is projected to improve to 6.0%.

- The drop in demand accompanying the global slowdown and fall in commodity prices has eased inflation pressures in developing Asia. Prices are expected to increase by 2.4% in 2009, a considerable drop from the 2008 pace. Even with the global recovery anticipated to begin in late 2010, inflation should stay largely in check with the rate projected to continue at 2.4%.

- Growth in East Asia is forecast to decelerate to 3.6% in 2009, pulled down by declines in exports of manufactures and knock-on effects on incomes and investment. While the PRC is expected to expand by 7.0%, Hong Kong, China; Republic of Korea; and Taipei,China will contract. Inflation is expected to average less than 2%, except in Mongolia where it will ease but still be much higher than elsewhere in the subregion. Most of East Asia's economies will record current account surpluses. In 2010, East Asia's GDP growth is forecast to bounce back to 6.5% as global trade picks up and stimulus packages have a positive impact.

- Growth in the PRC is seen slowing to 7.0% this year, as exports decline and private investment subsides. Private consumption, though, is expected to remain relatively buoyant. Both public consumption and investment will be bolstered by the fiscal stimulus measures being rolled out by the Government. Inflation is expected to average less than 1%. The current account surplus, while narrowing slightly, will be substantial, and foreign exchange reserves will soar past $2 trillion this year. GDP growth in 2010 is forecast to pick up to about 8%.

- Southeast Asia's growth is projected to dwindle to just 0.7% this year, with output contracting in the highly trade-exposed countries of Malaysia, Singapore, and Thailand. Inflation will decelerate to 3.3%, less than half the 2008 rate. In aggregate, the current account surplus will ease slightly, but most of the bigger economies are expected to record surpluses. Next year, all these economies are seen rebounding and recording moderately high growth rates.

- Growth in South Asia is expected to slow across the subregion in 2009. India will likely see only a 5% expansion, while Maldives, Pakistan, and Sri Lanka are expected to experience marked slowing. With little room for fiscal stimulus, these countries need to rely on monetary and structural policies to mitigate the headwinds from the global economic downturn.

- While not highly open, the economies of South Asia are still vulnerable to balance-of-payments pressures. Bangladesh, Pakistan, Nepal, and Sri Lanka all rely heavily on workers' remittances to offset large trade deficits, and their exports are concentrated in garments and textiles. Both sources of foreign exchange showed signs of weakening in 2008, possibly emerging as constraints.

- In Central Asia, growth is forecast to decelerate further to just 3.9% in 2009 and to less than 5% in 2010. This is mainly due to a further slowing in Kazakhstan to only 2% growth this year as the country continues to grapple with its banking problems. Growth is expected to fall to low levels in all the non-oil-producing countries, reflecting the full impact of the global economic slowdown in the Russian Federation, the subregion's main trade and financial partner.

- With slower economic expansion and weaker commodity prices, inflation is expected to moderate in Central Asia. The major macroeconomic challenge in 2009–2010 is keeping the balance-of-payments strains from reaching levels that would threaten growth in Armenia, Georgia, Kyrgyz Republic, and Tajikistan. These countries rely heavily on remittances from workers in Kazakhstan and the Russian Federation, and these inflows may well be curtailed by more than is now expected. Moreover, the adequacy of capital inflows is also at risk in light of the global credit crunch.

- Aggregate growth in the Pacific is set to slow to 3% in 2009, largely because Papua New Guinea's expansion will abate after 2 years of strong growth driven by the commodity boom. Fiji Islands is expected to slip back into contraction, hurt by the negative impact of the global slowdown on tourism and remittances as well as by severe flooding in early 2009. Inflation is expected to ease in all Pacific countries. Subregional growth is projected to remain close to 2009 levels next year.

- These deteriorating economic prospects will hinder the efforts to reduce poverty in developing Asia over the next 2 years. The consequences of the global slowdown for achieving the Millennium Development Goals are huge: had growth continued at the robust pace of 2007, more than 60 million additional people would have been lifted from poverty in 2009.

- Recognizing the adverse effects of the weaker regional outlook, developing Asia's governments have acted quickly. Many have begun fiscal stimulus packages and others have announced plans to follow suit. However, there is a dearth of information regarding the form, size, and implementation mechanisms of such packages. The overall impact on regional growth thus remains unclear.

Rebalancing growth

- Export-led growth has delivered enormous benefits to the region and will continue to do so. However, the pronounced impact of the current global downturn—in particular the synchronized recession of the G3—on developing Asia's growth underlines the risks of excessive dependence on external demand.

- The region's large and persistent current account surpluses are an integral part of the global imbalances underlying the current global financial crisis. Well before the outbreak of the current financial crisis, the region may have been paying a heavy price for its output–expenditure imbalance. This price includes not only welfare costs associated with consuming too little, but also opportunity costs arising from failure to use savings productively. Thus, rebalancing growth is fundamentally in developing Asia's self-interest.

- Bolstering domestic demand in response to weakened external demand requires a combination of policy measures. Given the diverse nature and underlying causes of developing Asian countries' current account positions, the optimal policy mix for rebalancing will necessarily differ by country. Nevertheless, effective rebalancing will require both policies that reinforce domestic demand and those that revitalize the domestic economy. For example:

  - Strengthening domestic consumption requires policies that transfer more corporate savings to households, as well as policies that reduce the precautionary motive for savings among households.

  - Governments should give priority to enhancing the investment climate rather than quantitative expansion of investment.

  - A more active fiscal policy can mitigate weak external demand in the short run as well as lay the foundation for more robust domestic demand in the medium to longer term.

  - Supply-side policies that promote small- and medium-sized enterprises and service industries will bolster production from firms that cater to domestic demand.

  - Policies pertaining to financial development and adjustment of the exchange rate can promote a better balance between domestic supply and demand.

- A concerted global effort is required to effectively address global imbalances. Strengthened regional cooperation can provide developing Asia with additional resilience, even against such a large external shock as an abrupt unwinding of global imbalances.

Table 1 Growth rate of GDP (% per year)						Table 2 Inflation (% per year)				
Subregion/economy	2006	2007	2008	2009	2010	2006	2007	2008	2009	2010
Central Asia	**13.3**	**12.0**	**5.7**	**3.9**	**4.8**	**9.0**	**11.2**	**16.2**	**10.6**	**7.8**
Azerbaijan	34.5	25.4	10.8	8.0	6.7	8.3	16.7	20.8	12.0	7.0
Kazakhstan	10.7	8.9	3.2	2.0	3.3	8.6	10.8	17.3	10.0	6.4
East Asia	**9.4**	**10.4**	**6.6**	**3.6**	**6.5**	**1.6**	**3.9**	**5.4**	**1.1**	**1.3**
China, People's Rep. of	11.6	13.0	9.0	7.0	8.0	1.5	4.8	5.9	0.8	1.0
Hong Kong, China	7.0	6.4	2.5	-2.0	3.0	2.0	2.0	4.3	1.5	2.0
Korea, Rep. of	5.1	5.0	2.5	-3.0	4.0	2.2	2.5	4.7	2.0	2.0
Taipei,China	4.8	5.7	0.1	-4.0	2.4	0.6	1.8	3.5	0.6	1.2
South Asia	**9.0**	**8.6**	**6.8**	**4.8**	**6.1**	**5.9**	**5.5**	**9.6**	**5.6**	**4.4**
Bangladesh	6.6	6.4	6.2	5.6	5.2	7.2	7.2	9.9	7.0	6.5
India	9.7	9.0	7.1	5.0	6.5	5.4	4.7	8.7	3.5	4.0
Pakistan	5.8	6.8	5.8	2.8	4.0	7.9	7.8	12.0	20.0	6.0
Sri Lanka	7.7	6.8	6.0	4.5	6.0	10.0	15.8	22.6	8.0	6.0
Southeast Asia	**6.0**	**6.4**	**4.3**	**0.7**	**4.2**	**7.1**	**4.0**	**8.8**	**3.3**	**4.1**
Indonesia	5.5	6.3	6.1	3.6	5.0	13.1	6.4	10.3	6.3	6.9
Malaysia	5.8	6.3	4.6	-0.2	4.4	3.6	2.0	5.4	1.5	2.4
Philippines	5.4	7.2	4.6	2.5	3.5	6.2	2.8	9.3	4.5	5.0
Singapore	8.4	7.8	1.1	-5.0	3.5	1.0	2.1	6.5	0.5	2.0
Thailand	5.2	4.9	2.6	-2.0	3.0	4.6	2.3	5.5	0.5	1.5
Viet Nam	8.2	8.5	6.2	4.5	6.5	7.5	8.3	23.0	4.0	5.0
The Pacific	**2.0**	**2.8**	**5.1**	**3.0**	**2.7**	**3.0**	**3.6**	**9.6**	**6.2**	**4.9**
Fiji Islands	3.4	-6.6	1.2	-0.5	0.2	2.5	4.8	7.7	4.5	4.5
Papua New Guinea	2.6	6.5	7.2	4.0	3.5	2.4	0.9	10.8	7.0	6.0
Developing Asia	**8.9**	**9.5**	**6.3**	**3.4**	**6.0**	**3.3**	**4.4**	**6.9**	**2.4**	**2.4**

Notes: Developing Asia refers to 44 developing member countries of the Asian Development Bank and Brunei Darussalam, an unclassified regional member; East Asia comprises People's Republic of China; Hong Kong, China; Republic of Korea; Mongolia; and Taipei,China; Southeast Asia comprises Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam; South Asia comprises Islamic Republic of Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka; Central Asia comprises Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan; and The Pacific comprises Cook Islands, Fiji Islands, Kiribati, Republic of the Marshall Islands, Federated States of Micronesia, Nauru, Papua New Guinea, Republic of Palau, Samoa, Solomon Islands, Democratic Republic of Timor-Leste, Tonga, Tuvalu, and Vanuatu.

Data for Bangladesh, India and Pakistan are recorded on a fiscal year basis. For India, the fiscal year spans the current year's April through the next year's March. For Bangladesh and Pakistan, the fiscal year spans the previous year's July through the current year's June.

Part 1

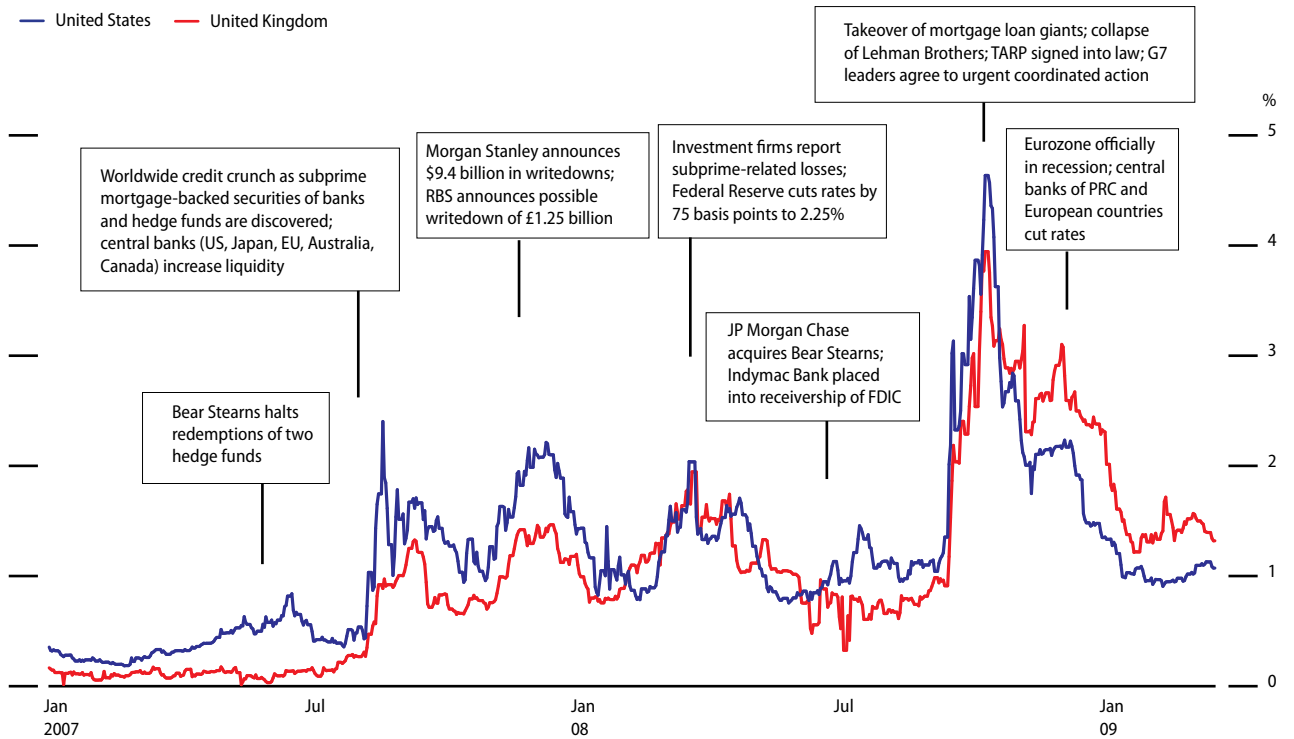
Enduring the uncertain global environment

Enduring the uncertain global environment

Anatomy of a global crisis

The global economic slowdown has its roots in a boom-bust cycle in the United States (US) subprime mortgage market—a relatively small niche in the financial sector. Several critical points are evident in the evolution from subprime mortgage market failures to a widespread financial crisis that eventually erupted into today's global crisis (Figure 1.1.1). Movements in the risk premium on interbank lending (the TED spread) point to the main events along the path.

1.1.1 TED Spread and timeline of key events over the period



Note: The TED spread is the difference between 3-month LIBOR and the yield on 3-month Treasuries.

EU = European Union; FDIC = Federal Deposit Insurance Corporation; PRC = People's Republic of China; RBS = Royal Bank of Scotland; TARP = Troubled Asset Relief Program; US = United States.

Source: Bloomberg, downloaded 16 March 2009.

Click here for figure data

This chapter was written by William James, Shikha Jha, Juthathip Jongwanich, Donghyun Park, Lea Sumulong, Akiko Terada-Hagiwara, and Joseph E. Zveglich, Jr. Rana Hasan provided material on the poverty impact of the economic slowdown on developing Asia. All writers are from the Economics and Research Department, ADB, Manila.

Financial institutions were beginning to write down the value of mortgage-backed securities in their portfolios in 2007, but the first shock came when the US investment bank, Bear Stearns, halted redemptions on two hedge funds linked to mortgages. Subsequently, just as the risk premium was settling back, came a loss of confidence in the value of securitized mortgages, as the extent of the ownership of these securities across the global banking system became known. One of the first victims of the credit crunch was Northern Rock, a highly leveraged medium-sized mortgage lender in the United Kingdom (UK), which suffered a bank run in mid-September 2007.

Northern Rock's problem proved to be an early indication of the troubles that would soon befall other banks and financial institutions. Although there were some signs of slowing economic activity in the US, UK, and eurozone linked to the global financial crisis even in 2007, worldwide the problems were still largely contained to the financial sector, and particularly to institutions with direct exposure to mortgage-backed securities. Then came September 2008 when, in quick succession, the US Government took over mortgage giants Fannie Mae and Freddie Mac; US investment bank Lehman Brothers collapsed; and global insurance company AIG filed for bankruptcy.

As the credit squeeze became acute in September 2008, the strains on the financial sector were transmitted to the real sector. Medium-term forecasts for growth in the major industrial countries became progressively gloomier, with the most pessimistic forecasters projecting a contraction in world gross domestic product (GDP) for the first time since World War II. World trade volume will almost certainly contract at a rate not seen in 25 years.

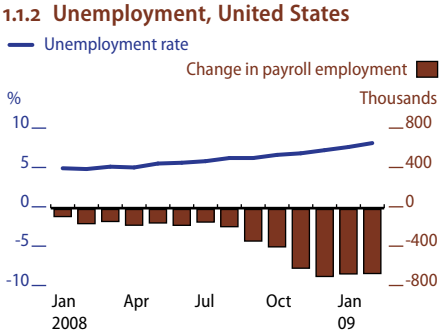
The following pages document the outbreak of the crisis in its epicenter, the US, starting with the unwinding of the housing asset bubble and the deleveraging of banks, hedge funds, and other financial players. It then shows how the contagion spread to the countries of the Organisation for Economic Co-operation and Development (OECD)—and beyond.

Origins of the crisis in the United States

The National Bureau of Economic Research (2008) officially dates the start of the recession as December 2007, the peak in an expansion of 73 months from November 2001. The downturn was most clearly signaled by shrinkage in nonfarm payroll employment, which has contracted in every month since the peak in the business cycle. In contrast to payroll employment, real growth of GDP, measured either as output or income, gave mixed signals.

The acceleration of monthly job losses has become increasingly severe, beginning in the fourth quarter of 2008. The Bureau of Labor Statistics (2009) estimates that a total of 4.4 million payroll jobs have been lost since the current recession began. The rate of unemployment in January 2009 stood at 7.6%, up from 4.9% a year earlier; in February 2009 the rate came in at 8.1%, reflecting upwardly revised estimates of job losses (161,000) and of unemployed people in December 2008 and January 2009. There is a danger that the unemployed may reach 10% or more of the active labor force (Figure 1.1.2).

1.1.2 Unemployment, United States



Source: US Department of Labor, Bureau of Labor Statistics, available: http://www.bls.gov, downloaded 15 March 2009.

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Moreover, job losses within all sectors combined were directly correlated with educational attainment—an indication that good jobs were being lost faster than low-level ones, despite the offsetting gains. Job losses among women were fewer than among men.

Housing market collapse

Housing prices continue in free fall as personal consumption expenditure declined for 2 consecutive quarters in 2008 (Figure 1.1.3). By year-end, the value of US housing had fallen by $3.3 trillion and one sixth of homes had negative equity (that is, a house price less than the unpaid mortgage balance). Since 2006 when home prices began their retreat, the value of home equity has fallen by nearly half of US GDP ($6.1 trillion). After rising continuously for almost 40 quarters, home prices have now fallen in 8 consecutive quarters. The drop in prices is widespread, with 90% of 161 metropolitan areas surveyed showing declines in the fourth quarter of 2008.

Sales of existing homes fell by 3.5% in December 2008 compared with the previous year. Sales of new homes fell by 44.8% in December 2008 and the overhang of supply was equivalent to 12.9 months of sales. In January, things worsened as the annualized rate of new home sales fell to 322,000—the lowest number recorded since the data series began in 1963. At that rate, eliminating the outstanding overhang of new housing supply over demand will take more than a year.

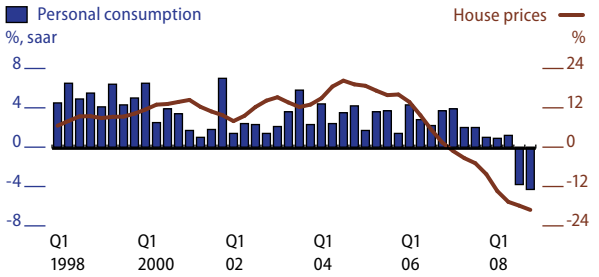
Housing starts have fallen to a record low and the home-building industry is deeply depressed. Valuation of residential mortgage-backed securities is problematic and contributes to the current financial malaise. Commercial property is also coming under stress and this will create further strains as commercial mortgage-backed securities suffer from downward pressure.

Mortgage-backed securities were initially priced on the premise of high and rising housing prices and rents. The market valued these securities on the optimistic view that homeowners could service the underlying mortgage loans because housing prices would continue their upward trajectory. In this environment, investment banks had strong incentives to maximize sales of mortgage-backed securities as a means of increasing the return on equity.

The opaqueness of these securities and the precise mixture of risk that they represent have compounded the problem of valuation and have added to the crisis of confidence in financial markets. The investment banks had huge positions in collateralized debt obligations that, in turn, were insured with large insurance companies in the form of credit default swaps. Initially, it was thought that subprime mortgages would amount to a relatively small problem of a couple of hundred billion dollars but the fact that these mortgages were securitized and sold around the world magnified the scale of the problem.

The mortgage crisis is far from over as the delinquency rate of a large set of variable-interest mortgages known as Alt-A—those considered riskier than prime mortgages but less

1.1.3 Personal consumption and house price changes, United States



saar = seasonally adjusted annualized rate.

Sources: US Department of Commerce, Bureau of Economic Analysis, available: http://www.bea.gov; Standard & Poor's Case-Shiller Home Price Indices, available: http://www2.standardandpoors.com, both downloaded 16 March 2009.

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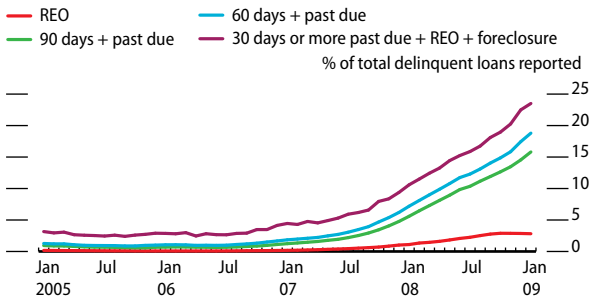
1.1.4 Delinquent Alt-A residential mortgages, United States



Note: REO, or real estate owned properties are those in possession of a lender, typically a bank, due to foreclosure of forfeiture.

An Alt-A mortgage, short for Alternative A paper, is a type of US mortgage that, for various reasons, is considered riskier than A paper, or prime, and less risky than subprime.

Source: Bloomberg, downloaded 14 March 2009.

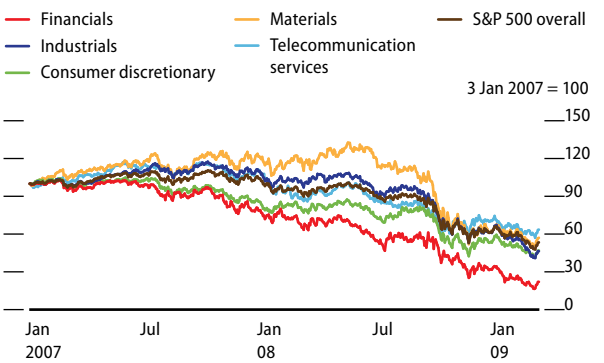
Click here for figure data

risky than subprime—is set to accelerate in 2009 as interest rates are reset and "balloon" payments of principal begin to kick in. This can be seen already in the rising percentages of delinquent residential mortgages in this category (Figure 1.1.4 above). Foreclosures have also been climbing sharply in recent months as the banking crisis has deepened. The state of the banking and financial sector is precarious: capital has continued to crumble despite huge injections of funds by the Treasury and the Federal Reserve.

Equity markets routed

Between the peak in the stock market in October 2007 and 11 March 2009, the Dow Jones Industrial Average fell by nearly 54% and the S&P 500 Index by 57%. The scale of the decline in equities since 2007 has been huge. The market capitalization of the New York Stock Exchange, by far the largest in the world, was estimated at end-2007 at $15.7 trillion. By September 2008 it had already fallen to $13.0 trillion, and has clearly dropped a great deal more since then. For example, on 29 September 2008 alone, an estimated $1.2 trillion was lost in the largest single-day loss on the Industrial Average. By end-February 2009, estimated market capitalization of the New York Stock Exchange was $8.7 trillion, for a $5.9 trillion loss of wealth in little over a single year (WFE database).

1.1.5 S&P 500 Index



Source: CEIC Data Company Ltd., downloaded 14 March 2009.
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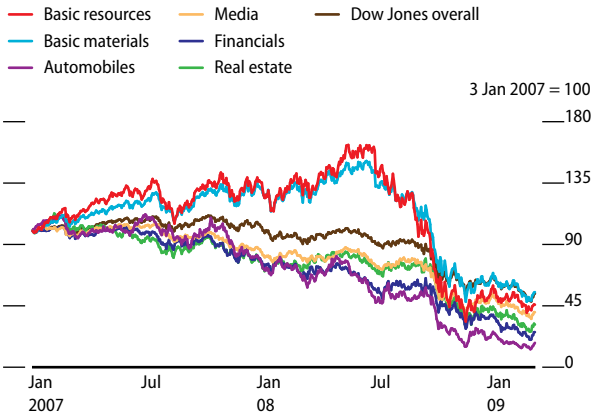
The plunge in stock prices has hit virtually all industries (Figures 1.1.5 and 1.1.6). The automotive and financial sectors have been hit hardest despite the efforts of the Government to bail them out. Share prices of leading banks and automobile companies have collapsed and remain weak despite injections of capital and access to facilities provided by the Federal Reserve.

The declines have also been steep, through early March 2009, in sectors that were booming even as late as mid-2008, such as materials and basic resources, and telecommunication services. Thus the pain is widespread and deep. Equities continued to plummet with the Dow Jones Industrial Average tumbling by 18.3% and the S&P 500 Index down by 18.8% from the beginning of the year through 13 March.

1.1.6 Dow Jones index



Source: CEIC Data Company Ltd., downloaded 14 March 2009.
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Trade and retail sales imploding

The spread of the crisis from the financial sector to the real economy manifested itself early in trade and retail sales data. Retail sales fell sharply during the fourth quarter of 2008, and preliminary data for the first quarter of 2009 indicate that the decline has not halted. In January 2009, seasonally adjusted retail sales fell by 10.25% compared with January 2008, although month-on-month sales rose by 1.0% from December 2008. Prices of many products are now moving down, though not as rapidly as asset prices. Prices and sales volumes of clothing, other nondurable goods, and durables are all declining.

Imports of consumer products are falling in volume but even more so by value, implying deflation of unit prices. This can be seen with clothing where unit prices of imports

from major Asian suppliers are, for the most part, declining (Figure 1.1.7). Unit prices of imports from Bangladesh and the People's Republic of China (PRC) are exceptions.

Aggregate demand faltering

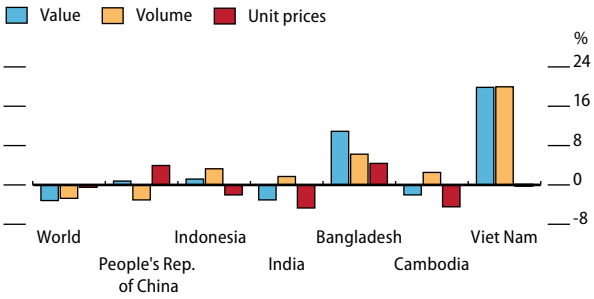
Macroeconomic indicators for the end of 2008 show accelerated weakening of the real economy after the fall of Lehman Brothers. Real GDP contracted at an annualized rate of 6.3% in the fourth quarter of 2008, a chilling revision in the previously released GDP number of a contraction of 3.8% (Figure 1.1.8). Every category of demand growth (other than government consumption) appears to be contracting and is set to deteriorate further in 2009. In the current atmosphere of uncertainty, many companies are delaying investments, cutting production aggressively, and reducing unwanted inventories. In durable goods production such as automobiles, excess inventories are a particular problem, straining profits and forcing manufacturers to reduce further their production and labor force.

The demand-side components of growth, particularly personal consumption and gross fixed capital formation, contracted in the third and fourth quarters of 2008. The slowing demand has affected US imports as well. Imports of goods, when adjusted to take account of the elevated price of energy in 2008, show a distinct slowdown, and this has affected the exports of US trade partners. US imports (excluding mineral fuels) from all suppliers contracted by 3.5% in 2008 in real terms (Figure 1.1.9). However, the slowing of US exports was even more dramatic. Net exports had buttressed growth through six consecutive quarters in 2007–2008 but that support evaporated in the fourth quarter of 2008. It is expected that in the short term, fiscal stimulus will be about the only positive component of growth. This is clearly unsustainable and the pattern of growth will eventually have to be rebalanced.

Persistent US current account imbalances

US personal saving as a share of disposable income had deteriorated to 1.0% or less for 3 years (2005–2007) and remained very low through the first quarter of 2008. However, as the crisis deepened, it rose sharply to reach 3.2% in the fourth quarter of 2008. Disposable income peaked in the second quarter of 2008 at $10.8 trillion but has fallen in the subsequent 2 quarters. The upward trend in personal saving (Figure 1.1.10) and the sharp decline in gross fixed capital formation are forcing a reduction in the current account deficit relative to GDP. The deficit has narrowed from its lowest point in 2006 and was 4.7% of GDP in 2008 (Figure 1.1.11). It is expected that the deficit will continue narrowing, implying that US imports of goods and services will fall more sharply than exports of goods and services, as US expenditure is forced to fall relative to income or output.

1.1.7 Change in US clothing imports, 2008



Source: Office of Textiles and Apparel, available: http://otexa.ita.doc.gov, downloaded 17 February 2009.

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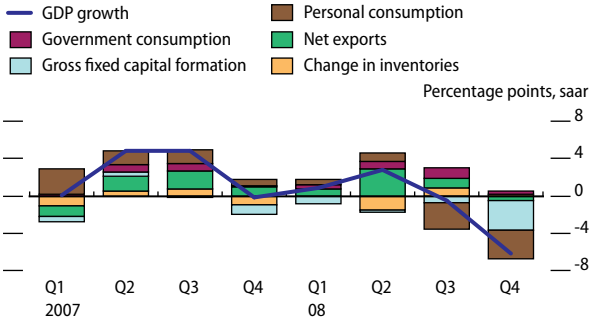
1.1.8 Contributions to GDP growth, United States



saar = seasonally adjusted annualized rate.

Source: US Department of Commerce, Bureau of Economic Analysis, available: http://www.bea.gov, downloaded 14 March 2009.

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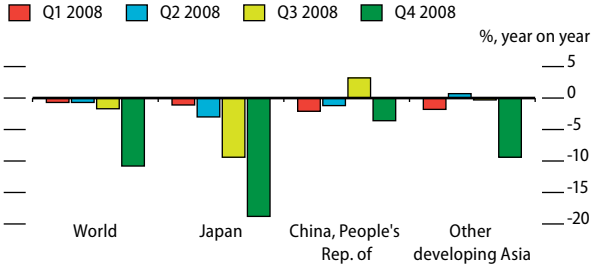
1.1.9 Growth in US real imports (excluding mineral fuels) from the rest of the world



Note: Other developing Asia comprises India, Indonesia, Malaysia, Republic of Korea, Singapore, Thailand, and Viet Nam.

Sources: United States International Trade Commission, available: http://datawebe.usitc.gov.; US Department of Labor, Bureau of Labor Statistics, available: http://www.bls.gov, both downloaded 6 March 2009.

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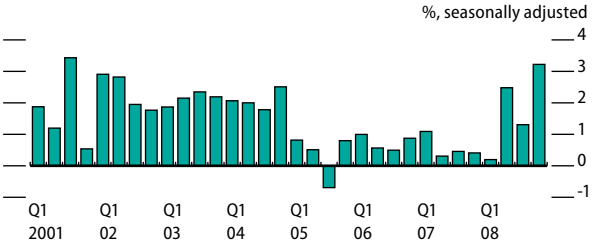
As the private saving–investment balance improves, however, the public sector is pulling things in the opposite direction. Fiscal stimulus and declines in revenue widened the US consolidated budget deficit in 2008, a position that will be exacerbated in 2009 with a budget deficit topping $1.8 trillion. Over the medium term, vigorous effort will be necessary to reduce the fiscal deficit once the recovery is under way. It would be a mistake to do this prematurely, though. Yet financing the gaping budget deficit may prove difficult and may result in monetization of the deficit with inflationary implications in the future.

In a difficult economy, there is a lurking danger of protectionism—despite the collapse of world trade—as evidenced, for example, in "buy American" clauses in the US fiscal stimulus approved in January 2009. Protectionism may be held in check—at least some signs point that way—partly because the fiscal stimulus bill has a clause stating that it must operate in a manner consistent with World Trade Organization (WTO) and other trade treaty commitments. Yet the support provided to individual industries (such as automobiles) may be subject to challenge in WTO. In addition, there appears to be little likelihood that attention will be given to reviving the Doha Round negotiations or in ratifying new free trade deals with, for example, Republic of Korea (hereafter Korea), Colombia, and other countries.

1.1.10 Personal saving rates, United States



Source: Bureau of Economic Analysis, available: http://www.bea.gov, downloaded on 14 March 2009.

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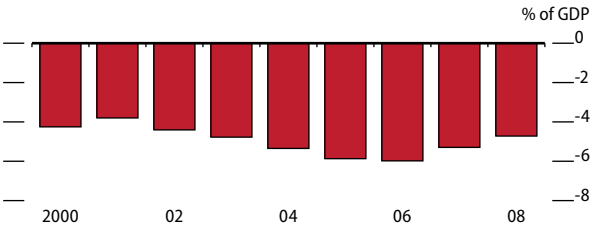
1.1.11 Current account balance, United States



Source: CEIC Data Company Ltd., downloaded on 18 March 2009.

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The spread of the crisis to Europe and Japan

The crisis that was spawned in the US spread quickly to other OECD countries. Housing bubbles in the UK and in parts of the eurozone became noticeable almost immediately after the subprime crisis began in the US in August 2007. The large mortgage lender, Northern Rock, ran into funding difficulties in September 2007 and asked for help from the Bank of England. The company had aggressively expanded its share of UK mortgage lending from 3.6% in 1999 to 9.7% in 2007 (Bank of England 2008) and had financed this expansion through securitization of its assets.

In a situation of deteriorating credit and money market conditions, Northern Rock faced difficulties in meeting its debt obligations amid doubts about the value of its assets. The spread between its borrowing and loan rates plunged and the company approached the monetary authorities for help. Liquidity support provided by the Bank of England could not save it from bankruptcy and in early 2008 the Government had to place the company in public ownership.

The US subprime crisis spread to the continent, as European investors' exposure to toxic assets became clear. For example, Dexia Group (a French–Belgian lender incorporated in Luxembourg) had exposure to subprime residential mortgage-backed securities through its affiliate Financial Security Assurance. This latter company had to write down losses of over $750 million in the first half of 2008 and saw its credit rating downgraded by Standard & Poor's from AAA+ to AAA- and then to AA-. Soon the governments of Belgium, France, and

Luxembourg had to jointly inject $9 billion into Dexia after its shares plunged by 30%.

Investors' fears of losses from exposure to the subprime-backed derivatives through the investments by big European banks in failed US investment banks such as Bear Stearns and Lehman Brothers were palpable.

United Kingdom

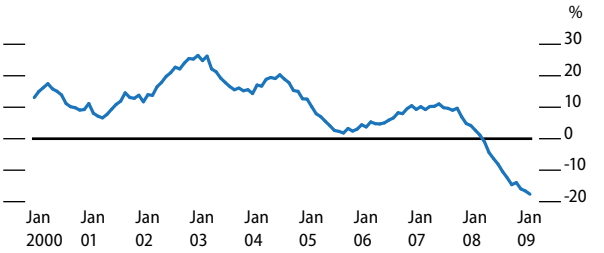
The UK has similar problems to the US in terms of rising current account deficits since 1998 and a persistent budget deficit since 2001. Consumer credit had expanded at double-digit rates for a prolonged period (1998–2005), fueling a housing bubble that extended throughout 2007 before housing prices began to fall in the second quarter of 2008 (Figure 1.1.12). High levels of debt finally drove consumers to slow spending in the second quarter. Nonetheless, weak GDP growth of 0.7% in 2008 was largely a result of the sharp slowdown in gross capital formation that year (Figure 1.1.13). GDP growth was flat in the second quarter of 2008, and the country fell into recession in the second half of the year.

In 2008 the deepening of the housing crisis led to the collapse of the large mortgage lender Bradford and Bingley, forcing the UK Treasury to take over that institution. The Government then moved quickly to inject large sums of new capital into the banking system, providing support to some large banks in an unprecedented move. These banks had yet to record subprime write-offs, unlike their US counterparts. A clear sign that the UK was on a precipice is the sharp increase in LIBOR that occurred in late September and its widening spread over Treasuries, reaching about 400 basis points on 8 October 2008 (Figure 1.1.14).

The capitalization of the London Stock Exchange has fallen dramatically from $3.9 trillion at end-2007 to $1.6 trillion in February 2009 (WFE database). The depreciation of the pound, combined with lower share values, pushed the relative position of the London Stock Exchange down the list of global equity markets in terms of market capitalization. The loss of wealth on the part of UK shareholders is likely to have negative repercussions for consumption and investment and may deepen the UK recession.

Industrial production started to decline in May last year, coinciding with the contraction in the eurozone (see below). Deteriorating business sentiment with falling export orders and output expectations lowered business investment and GDP contracted by 6.0% in the last quarter of 2008, the third consecutive quarter of contraction. Growth of consumer credit slowed from 14.3% (year on

1.1.12 House price changes, United Kingdom



Source: CEIC Data Company Ltd., downloaded 14 March 2009.
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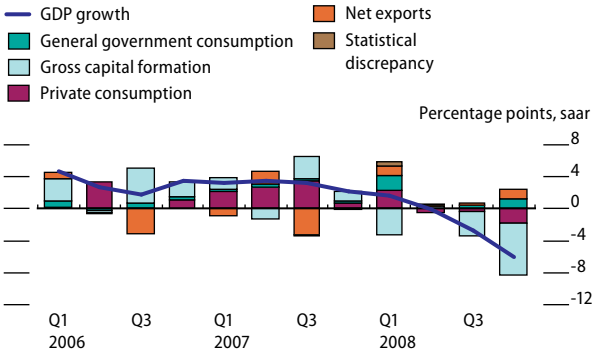
1.1.13 Contributions to GDP growth, United Kingdom



saar = seasonally adjusted annualized rate
Source: CEIC Data Company Ltd., downloaded 20 March 2009.
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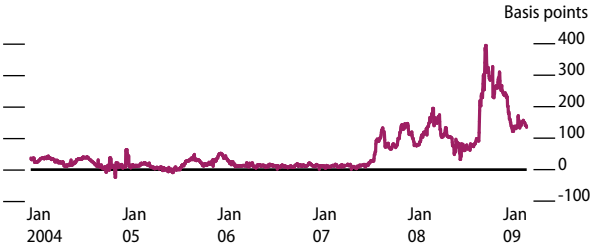
1.1.14 TED spread, United Kingdom



Note: The TED spread is the difference between 3-month LIBOR and the yield on 3-month Treasuries.
Source: Bloomberg, downloaded 16 March 2009.
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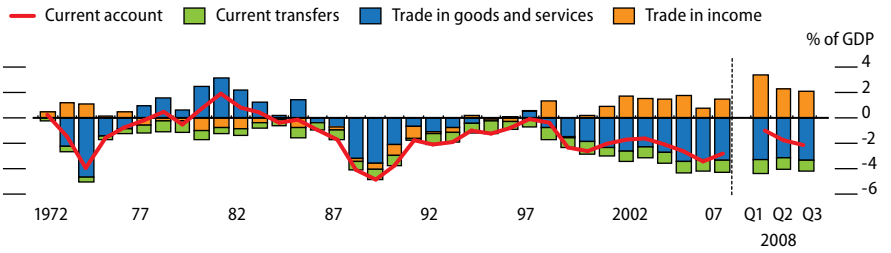
1.1.15 Current account balance, United Kingdom



Source: CEIC Data Company Ltd., downloaded 16 March 2009.
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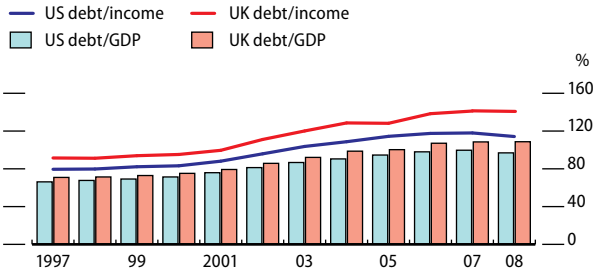
year) in 2004 to 4.5% in January 2009. For as long as housing prices continue to deteriorate, consumption demand is likely to weaken further.

On the external front, the current account deficit started to narrow—having exceeded 4% of GDP in the fourth quarter of 2006—to 2.1% in the third quarter of 2008 (Figure 1.1.15 above). The current account adjustments in the late 1970s and the early 1990s took place through an improving trade balance, but the UK's trade deficit remains above 3% of GDP. The narrowing of the current account deficit has been achieved through increased earnings on direct investment abroad by UK residents.

Consumer debt in the UK is even greater than that in the US relative to GDP and household income (Figure 1.1.16). Hence the outlook is grim and a prolonged recession is likely over the next 12–24 months. Manufacturing production is retreating and joblessness is on the rise.

1.1.16 Household debt indicators



Note: UK household income and outstanding debt is as of Q3 2008 only.

Sources: Board of Governors of the Federal Reserve System, available: http://www.federalreserve.gov; US Department of Commerce, Bureau of Economic Analysis, available: http://www.bea.gov; UK National Statistics, available: http://www.statistics.gov.uk/hub; CEIC Data Company, Ltd., all downloaded 20 March 2009.

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Eurozone

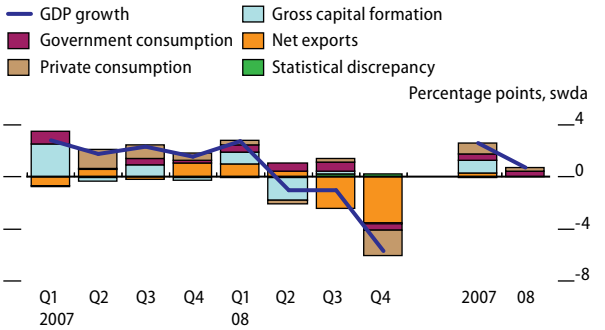
Macroeconomic conditions in the eurozone initially appeared to be less precarious than in the US. However, the region has been no exception to the global meltdown as credit conditions tightened in the Eurozone, with lending to nonfinancial companies and to households slowing sharply. The slowdown in 2008 reflected the damping effects of sharp increases in commodity prices in the first half of 2008 and the ongoing correction in the housing market in some eurozone countries.

Manufacturing production in the eurozone started to contract in the second quarter and had deteriorated sharply by December 2008. Inflation moderated to only 1.1% by January 2009, from 3.2% in January 2008. Investment and consumption have also flattened out. On the external front, the eurozone has several net capital importers such as Greece, Italy, Portugal, and Spain as well as capital exporters such as Finland and the Netherlands. This diversity makes the region more or less externally balanced. The current account balance turned to a deficit of 0.6% of GDP in 2008 from a surplus of 0.4% in 2007, and the euro accordingly turned around from its earlier appreciating trend and began depreciating in July.

Eurozone activity declined markedly in the second half of 2008 (Figure 1.1.17). After falling moderately in the second and third quarters of 2008, GDP growth contracted sharply in the fourth. This reflected not only a decrease in foreign demand for exports; domestic demand was also adversely affected by internal factors, notably very low confidence and tight financing conditions. Annual growth of 0.8% in 2008 was the slowest since the early 1990s.

The "Bank lending survey for the Euro Area" of the European Central Bank (ECB) suggests that poor expectations of future economic activity in general—along with weak industry- and firm-specific outlooks—has enterprises reassessing their borrowing plans (Figure 1.1.18). Corporate

1.1.17 Contributions to GDP growth, Eurozone



swda = seasonally and working days adjusted.

Source: CEIC Data Company Ltd., downloaded 12 March 2009.

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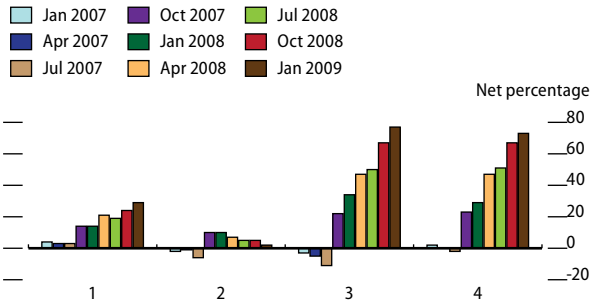
1.1.18 Bank lending survey, European Central Bank



1 = Costs related to banks' capital position; 2 = Competition from market financing; 3 = Expectations regarding general economic activity; 4 = Industry or firm-specific outlook.

Note: A positive (negative) net percentage indicates that a larger proportion of banks have tightened (eased) credit standards.

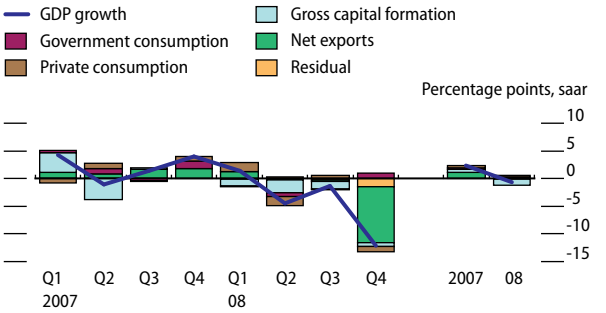
Source: European Central Bank, available: http://www.ecb.int, downloaded 12 March 2009.

Click here for figure data

restructuring and cutbacks in fixed investment underlie the declining demand. The weak economy has also affected household borrowing, leading to a considerable decline in bank lending overall. The drop in demand for loans from households was a reflection of worsening housing market prospects, deteriorating consumer confidence, and much lower financing needs for durable consumer goods.

The survey showed a positive development, however. It indicated that government announcements of recapitalization support and state guarantees for debt securities issued by banks supported banks' access to wholesale funding in the fourth quarter of 2008, which is reflected in a recovery in credit growth to nonfinancial sectors. Government initiatives have begun to ease access to funding in the first quarter of 2009. Nevertheless, banks reported that their access to money markets had remained broadly hampered as a result of the turmoil in financial markets.

1.1.19 Contributions to GDP growth, Japan



saar = seasonally adjusted annualized rate.

Source: Economic and Social Research Institute, Cabinet Office, Government of Japan, available: http://www.esri.cao.go.jp/en, downloaded 12 March 2009.

Click here for figure data

Governments in the eurozone are not all equally able to bear the costs of necessary fiscal stimulus and bank rescue packages, and this is driving divergence in government bond yields to wide levels. Economic divergence, too, is driven by economic fundamentals such as wage levels or, more generally, competitiveness. Ireland and Spain seem to be the most affected so far, with rising unit labor costs undermining competitiveness, leading to sharp increases in unemployment rates and appreciations of their real exchange rates. Financing the stimulus packages with a common "European government bond" could help reduce costs but governments' reluctance to cross-subsidize other states' imbalances will make such a common solution elusive.

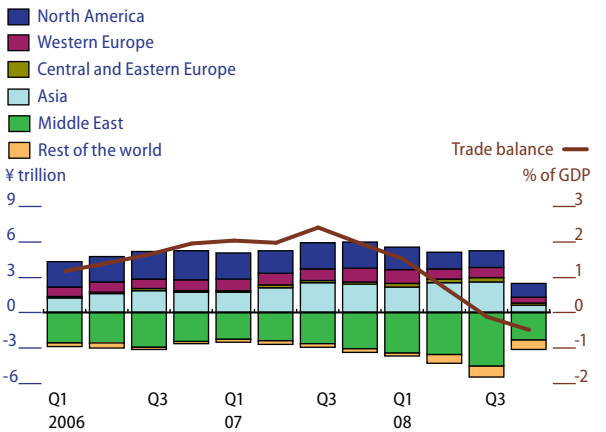
Japan

As the financial crisis deepened, Japan appeared to be well placed to weather the storm. In September 2008, the country's financial sector was in good condition with limited exposure to the toxic assets plaguing the US and Europe. Credit default swap premiums for Japanese banks remained relatively low, and in September were only 100 basis points compared with 700 basis points for US banks. Risks in funding yen-denominated liquidity were also limited because Japanese banks rely on deposits as their major funding source rather than short-term capital market funding.

Yet the economy had been weakening even before the collapse of global financial markets. Economic activity peaked in October 2007—ending almost 6 years of expansion—and entered a recession. GDP growth fell sharply from 2.4% in 2007 to a contraction of 0.6% in 2008 (Figure 1.1.19), driven by sharp declines in exports and gross capital formation, mainly the private investment component.

The current account surplus began to narrow in tandem with the appreciation of the yen. The yen has appreciated by about 40% in real trade-weighted terms since mid-2007, adding strains to the export sector. In 2008, exports declined by more

1.1.20 Trade balance, Japan



Note: Rest of the world includes Africa, Latin America, and Oceania.

Sources: Trade Statistics of Japan, Ministry of Finance, available: http://www.customs.go.jp; Economic and Social Research Institute, Cabinet Office, Government of Japan; available: http://www.esri.cao.go.jp/en, all downloaded 12 March 2009.

Click here for figure data

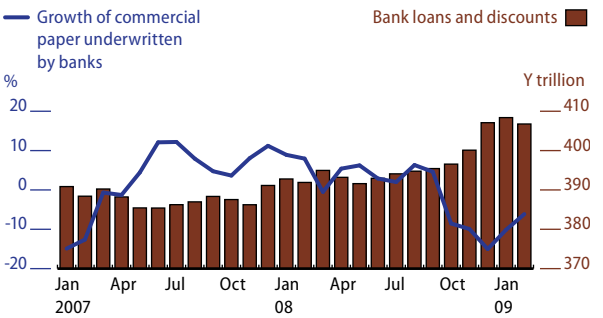
than imports. In real terms, the trade balance made an inconsequential contribution of 0.2% to growth. Manufacturing production and shipping—both sensitive to international trade movements—contracted sharply in the last quarter of 2008.

Japan maintains a trade surplus with the US, despite plummeting exports, but merchandise exports to major trading partners in Asia have dropped across all product groups, triggering an overall trade deficit beginning in the third quarter of 2008 (Figure 1.1.20 above). The widening trade gap has led Japan to run a current account deficit of $1.93 billion—the first current account deficit in 13 years.

Reacting to the slowing economy, Japanese firms reduced their workforces in 2008. Lay-offs—particularly among nonregular staff—rose (Box 1.1.1), but the biggest movement has been in hours worked. Unemployment stepped up to 4.4% by end-December, from 3.7% a year earlier, while aggregate weekly hours worked fell by 7.5% over the same period. Labor market indicators showed some improvement in January 2009, but it is too early to say whether this can be sustained. The slowing economy and job uncertainty led to sharp declines in consumer confidence in 2008.

Firms' reliance on bank loans grew as the cost of raising funds through capital market rose toward end-2008, and banks were increasingly reluctant to underwrite commercial paper after October (Figure 1.1.21). The central bank's decision to purchase commercial paper in October 2008 helped reverse this trend somewhat—with better-rated large firms resuming financing through this avenue—and bank loans began to decline somewhat in January 2009. Loans made by regional and trust banks are still increasing, which suggests that small and medium-sized enterprises may still be shut out from the capital market.

1.1.21 Bank loans and commercial paper, Japan



Source: Bank of Japan, available: http://www.stat-search.boj.or.jp; downloaded 13 March 2009.

Click here for figure data

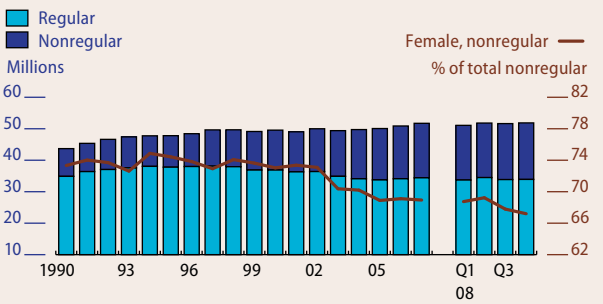
1.1.1 Nonregular employment in the Japanese labor market

The share of nonregular employment has increased steadily over the past two decades and now accounts for more than 30% of all employees (Box figure). This rise is mainly a result of firms seeking to cut labor costs—nonregular workers generally have lower wages and fewer benefits—and jobseekers, especially women, seeking greater flexibility in work arrangements.

Historically, labor market flexibility has been much lower than in the US, which made it difficult for firms to adjust their costs in downturns. This structural shift now points to greater flexibility, which could enable the economy to bounce back much faster than otherwise.

The Government has taken some measures to support nonregular workers during the global downturn—such as shortening the period that workers must contribute to qualify to receive unemployment benefits. However, the social safety net for these workers is still insufficient.

Employment, Japan



Source: Japan Statistics Bureau, Ministry of Internal Affairs and Communications, available: http://www.stat.go.jp, downloaded 13 March 2009.

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A crisis of global proportions

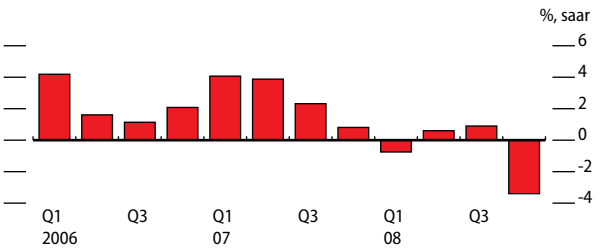
Before the financial crisis intensified and spread to the real sector, some economies seemed immune to the subprime crisis. Direct exposure to mortgage-backed securities was minor, at levels that would not suggest systemic risk to these economies' financial sectors. Yet as the major industrial economies slipped into recession, secondary weaknesses became apparent. Declining economic activity in the major industrial countries entailed a drop in import demand across the board such that no open economy would be spared. The global slowdown also exposed the record commodity price levels for what they were—just another asset class experiencing a speculative bubble. After the collapse of Lehman Brothers in September 2008, the crisis soon became truly global.

Canada and Australia

The Canadian economy was in relatively good shape at the outbreak of the crisis with a current account surplus buttressed by a budget surplus, solid GDP growth, and low inflation. Its banking and financial sector had little exposure to toxic assets and was well capitalized and regulated. Yet with over 80% of its merchandise exports headed to the US, even such a strong economy as this was not immune to the downturn.

The economy slowed sharply over the course of 2008, and contracted year on year by about 3.4% in the fourth quarter (Figure 1.1.22). It benefited from high commodity and energy prices through the first half of 2008, but the slump in commodity prices hurt its terms of trade in the second, and exports in the fourth quarter contracted by 9.7% from the previous quarter.

1.1.22 Real GDP growth, Canada



Source: Bloomberg, downloaded 3 March 2009.

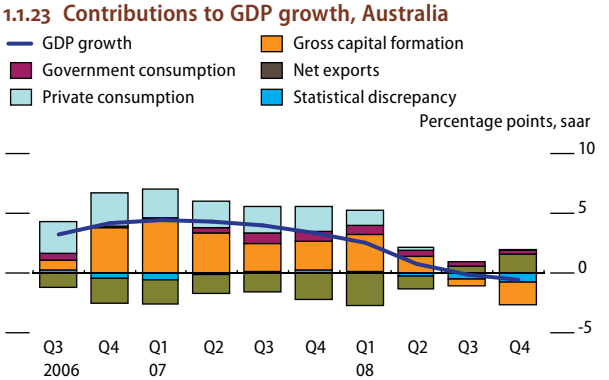
Click here for figure data

Like Canada, Australia's GDP growth slowed through the first 3 quarters, turning to a contraction of 0.5% in the fourth (Figure 1.1.23). For the year, exports grew rapidly, expanding by 33%, but like Canada weaker commodity prices and diminishing external demand slowed the pace of export growth toward the end of the year. Exchange rate flexibility cushioned Australia somewhat from the contraction in world trade.

However, unlike Canada, Australia's financial sector has not escaped the global turmoil. For example, the spread between policy rates (cut in recent months) and short-term interbank lending rates remains high. But credit continues to grow, slowly, and the banking system appears robust relative to those in US, UK, and parts of the eurozone.

Recent data on employment in both Canada and Australia show signs of resilience in both economies. Yet the outlook for both countries hinges critically on future commodity price developments.

1.1.23 Contributions to GDP growth, Australia



saar = seasonally adjusted annualized rate.

Source: Australian Bureau of Statistics, available: www.ausstats.abs.gov.au, downloaded 16 March 2009.

Click here for figure data

The Russian Federation and the Middle East

The global nature of the ongoing financial and economic crisis is nowhere better illustrated than in the oil-exporting economies of the Russian Federation and the countries of the Middle East. The reversal of oil prices that began in the third quarter of 2008 has turned into a rout, with prices at one stage falling to less than one third of their peak value in current

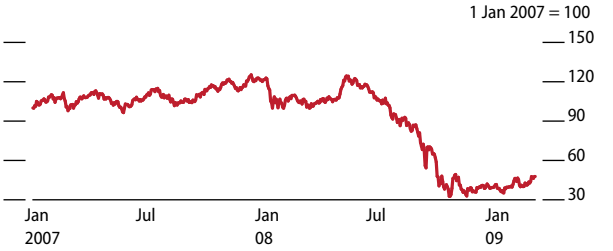
dollar prices. The proximate cause of the decline in oil prices is the collapse of demand worldwide, especially so in the US, where demand contracted by 6.1% in 2008. The rapid descent of oil prices seems to have stabilized in early 2009, helped by a cutback in production by the members of the Organization of the Petroleum Exporting Countries (OPEC) of an estimated 4.2 million barrels per day (see Box 1.2.2 on oil prices below).

The financial market volatility caught Russian corporate giants off guard and capital flight by foreign investors dealt a crushing blow to equity markets there (Figure 1.1.24). The sudden withdrawal of foreign funds with the loss of oil revenue put undercut the Russian rouble, and provision of credits by the central bank to domestic commercial banks fueled speculation against the local currency. High inflation and slumping growth presented a dilemma to the central bank, but its decision to hike interest rates in early 2009 and set a new, more depreciated trading band for the rouble in late January, succeeded in stemming the currency's fall. The erosion of international reserves, which had fallen from around $408 billion to $371 billion from July 2007 to January 2009, abated.

The collapse in oil prices also eroded the current account and fiscal surpluses, because oil accounts for about 30% of government revenue and about 60% of exports. Growth in 2008 fell sharply from the previous year to an estimated 6.0%, and the fourth quarter is likely to have shown a contraction. Unemployment jumped in early 2009 to 8.1% as an estimated 300,000 jobs were lost in January 2009 alone. Some relief may come from recovery in metal prices, particularly gold, but the employment effects of these exports are likely to be negligible. Retail sales growth slowed sharply from year-on-year growth of 4.8% in December 2008 to a contraction of 2.4% in February 2009.

The Middle East oil exporters are also reeling from the first decline in global oil consumption in a quarter of a century. The International Monetary Fund (IMF) estimates that growth of Middle East and North African oil exporters fell to 5.6% in 2008 from 6.1% the previous year. Although the current account balance remained stable as a share of GDP, this result was weaker than expected on the basis of the high oil prices in the first half of the year.

1.1.24 Moscow Interbank Currency Exchange index



Source: Bloomberg, downloaded 16 March 2009.

Click here for figure data

Global outlook for 2009–2010

Uncertainty clouds the outlook for the global economy despite broad-based efforts to create liquidity, shore up financial institutions, and enact fiscal stimulus programs (see Box 1.2.1). The collapse of credit markets, particularly in major industrial economies, and the abrupt and deep reduction in capital flows are holding back investment and compounding the impact of sharp reductions in production, retail sales, and international trade. Fear of job losses is also making consumers in the US and Japan reluctant to spend. Wealth effects from the huge declines in equity markets also weigh on sentiment and add to the downturn in spending by households and firms.

Turbulence in financial markets and continued weakness in recent economic data dominate the global outlook for 2009–2010. *Asian Development Outlook 2009* (*ADO 2009)* projects GDP in the US, eurozone, and Japan in 2009 to contract by 2.6% and world trade volume to decline by 3.5% (Table 1.2.1). A mild economic recovery is foreseen in late 2010, with growth in major industrial countries expected to average 1.1% and trade volume forecast to rise by 1.9%.

However, downside risks to this outlook are substantial, which could further slash the already dismal prospects. If crisis resolution schemes and fiscal stimulus packages are ineffective, this could drag down the current bleak forecasts for the US and elsewhere. Emerging protectionism is becoming worrisome. Commodity prices are likely to remain volatile. Deflationary risk is in sight, which could lead to further deterioration of labor markets, yet monetary policy options to combat this risk will be increasingly limited. Social instability could pose additional threats to economic prospects.

United States

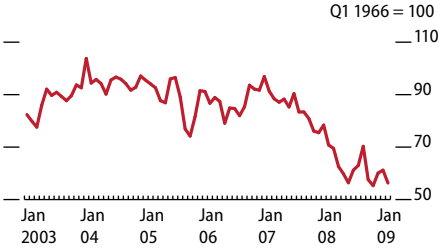
The rout in the US housing market shows no signs of abating as housing prices, sales, starts, and foreclosures all worsened in late 2008 and early 2009. Shell-shocked investors and households are heavily cutting back on spending. Personal saving as a share of disposable income has risen sharply. The University of Michigan Consumer Sentiment index reflects the cautious mood of US consumers, although the most recent index values are slightly above previous lows (Figure 1.2.1). The US trade deficit declined for 6 consecutive months from August 2008 through January 2009 as imports fell by a far greater amount than exports.

The fiscal and monetary policy responses will only cushion the fall in GDP in 2009; they will not reverse it until sometime in 2010. Thus the projection for US real GDP is a 2.4% contraction in 2009 and 1.6% growth in 2010.

The projected mild recovery is predicated on the housing and equity markets reaching bottom by late 2009, at which point fixed capital formation and consumption should begin to firm up.

Consumer prices in the US had fallen for 3 straight months (month-

1.2.1 University of Michigan consumer sentiment index



Source: Federal Reserve Bank of St. Louis, available: http://research.stlouisfed.org/fred2/series/UMCSENT, downloaded 16 March 2009.

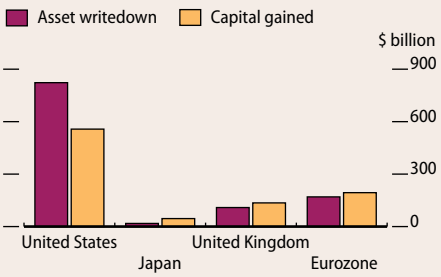
Click here for figure data

1.2.1 Policy responses to the crisis

The dramatic worsening of the financial crisis since mid-September 2008 has severely disrupted credit intermediation, slowing economic activity and pushing consumer and producer confidence to historically low levels. Major industrial economies are responding to these negative developments—albeit with varying speed and intensity. Wide-ranging policy actions have so far managed to prevent a global financial meltdown, but systemic risks and credit conditions remain a serious concern as the interest rate spreads between interbank loans and government debt are still elevated.

Initial crisis responses generally took direct aim at the financial sector. The issues are complex, ranging from ensuring stability of day-to-day credit flows to strengthening regulation and supervision. Governments have introduced various measures to support credit flows (mainly recapitalization of banks), to purchase nonperforming assets, and to lift banks' deposit insurance limits. As private banks' balance sheets deteriorated (Box figure 1)—particularly in the US and UK—public balance sheets were used to prop up ailing institutions. For example, the US Treasury introduced the $750 billion Troubled Asset Relief Program (TARP), which had injected $247 billion of equity capital into 218 institutions by end-2008. The UK authorities approved a similar plan in its Asset Purchase Facility. Financial sector responses have even gone to the extent of direct public ownership, as in the case of the US insurer AIG or the UK mortgage lender Northern Rock.

1 Writedowns and capital raised by major banks since Q3 2007



Note: Eurozone here comprises Belgium, France, Germany, Ireland, Italy, Netherlands, and Spain.

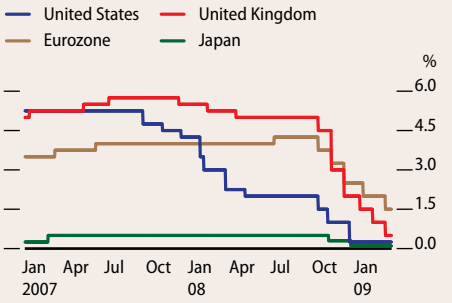
Source: Bloomberg, downloaded 17 March 2009.

Click here for figure data

Yet a raft of issues lies ahead for resolving distressed assets. Cleaning bank balance sheets will be critical to restoring confidence in financial institutions and reducing counterparty risk. A transparent approach, such as transferring the assets to a "bad" bank, would greatly reduce uncertainty, although it requires high fiscal costs initially. Experience from previous crises suggests that such a measure could work if those assets are adequately priced and managed. Recapitalization of a sufficient size would address solvency concerns, but it is not an easy task as banks' balance sheets are constantly—and heavily—exposed to a deteriorating macroeconomic environment.

The authorities coupled their immediate financial sector interventions with monetary responses to address the fears of a liquidity crunch, particularly in the US dollar money market. Conventional monetary policy easing started with a lowering of policy rates in the fourth quarter of last year. The US, Japan, and UK authorities have all cut nominal policy rates to nearly zero, but not the European Central Bank, where the refinancing rate was 1.5% in March (Box figure 2).

2 Policy rates, G3 and United Kingdom



Source: Bloomberg, downloaded 16 March 2009.

Click here for figure data

As risk premiums soared, the reduction in policy rates did not translate into lower borrowing costs for firms and households, prompting central banks to intervene directly in credit markets. Major central banks—notably in the US, Japan, and UK—have taken riskier assets as collateral to deflate risk premiums and to support credit markets. Initially extending collateral to commercial paper, they expanded their efforts to include even riskier assets such as mortgage-backed securities, syndicated loans, and various consumer loans. Public balance sheets, including those of central banks, have grown rapidly as a result.

With conventional monetary easing proving to be ineffective at stimulating short-term demand—as evidenced by the deepening global slowdown—authorities have turned to fiscal policy. Solving the financial sector problems will take time, making fiscal stimulus measures critical to support demand. Many countries have announced public spending and tax plans to support economic recovery (box table). There is considerable variation across countries, however, in the size, composition, and timing of stimulus packages. Assessing the likely impacts of the announced fiscal measures is difficult. The increase in GDP that is expected from a given fiscal measure—that is, the multiplier—depends on country circumstances and the choice of instrument.

1.2.1 Policy responses to the crisis *(continued)*

Fiscal policies in industrial economies, as of 16 March 2009

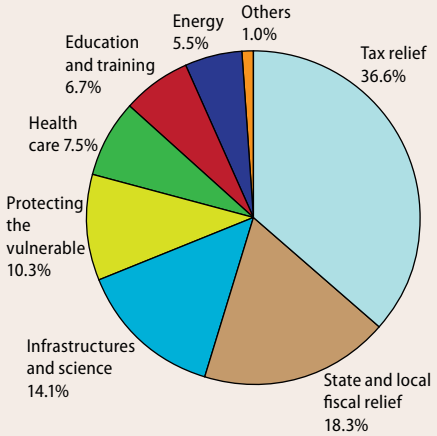
Economy	Size (% of GDP)
United States	5.5
Japan	2.0
Eurozone	1.5[a]
United Kingdom	1.0

[a] Of European Union GDP.

Source: Staff compilation from various news articles.

In the US, tax rebates were distributed in the first half of 2008 to help support growth. As the financial crisis intensified and global economic activity slowed, the US approved a $787 billion (5.5% of 2008 GDP) package, which includes spending on infrastructure, energy, and social sectors. The package also included tax relief for workers and credit support to distressed sectors—about 37% revenue measures—and transfers to support state and local budgets (Box figure 3). Infrastructure spending tends to have a larger impact on growth than tax cuts or transfers, but its effect may come with some delay. Given the size of the US fiscal package and mix of different instruments, the package is expected to support growth in the short term. However, the large public expenditure also raises concerns about medium-term fiscal sustainability.

3 Fiscal package components, United States



Source: Recovery.gov, available: http://www.recovery.gov, downloaded 13 March 2009.

Click here for figure data

In Europe, many countries have adopted fiscal stimulus packages. Germany introduced an €82 billion package comprising infrastructure investment, income tax cuts, health insurance contribution reductions, and other transfers and rebates. Italy has announced a €5 billion plan to step up public works, provide cash transfers to low-income households, and grant corporate tax breaks. Japan, whose economy has been shrinking since the second quarter of 2008, has also disclosed a sizable package focusing on infrastructure, technology, cash transfers, and subsidies to firms.

Other than the announced stimulus plans, many government programs act as automatic stabilizers in times of recession. Under a progressive income tax structure—one where rates rise with income—declining average income will put people into lower tax brackets. Transfers such as unemployment compensation and income supplements for the poor also increase when income in general drops. A larger impact of automatic stabilizers is projected in 2009—ranging from 1.5% to 2.0% of GDP in major industrial economies (IMF 2009)—which helps bolster demand.

As the crisis is global in nature, a coordinated, international response would be more effective. In response to strains on short-term foreign exchange markets, in September last year central banks worked together to extend funding across borders by significantly expanding the capacity to provide US dollar liquidity.

The Federal Reserve added another $330 billion by boosting its temporary reciprocal currency arrangements (swap lines) with nine industrial-country central banks, on top of the $290 billion swap lines previously available, and widened this support to central banks in Brazil, Republic of Korea, Mexico, and Singapore. Concurrently, Asian economies moved to strengthen existing swap lines under the Chiang Mai Initiative. The Bank of Japan and Bank of Korea agreed in December to raise their existing yen–won swap arrangement of $3 billion to $20 billion.

Coordination in other areas is still in its nascent stage. The meeting of G20 finance ministers and central bankers in March 2009 emphasized that large, sustained fiscal stimulus measures are needed to combat the global slowdown. As the financial sector is at the root of the current crisis, the G20 agreed to explore ways to strengthen regulation and supervision of financial institutions. While G20 members in their rhetoric continue to voice support for free trade, they must also in reality stem any further "home bias" that is creeping into crisis responses.

With economies slowing and unemployment rising across the world, the risk of trade protectionism is growing. Such counterproductive policy responses, which would lead to deterioration in market access, must be avoided at all costs.

1.2.1 Baseline assumptions for external conditions

	2007 Actual	2008 Actual	2009 *ADO 2009* projection	2010 *ADO 2009* projection
GDP growth (%)				
Major industrial countries[a]	2.3	0.7	-2.6	1.1
United States	2.0	1.1	-2.4	1.6
Eurozone	2.6	0.8	-2.6	0.5
Japan	2.4	-0.6	-3.5	1.1
Memorandum items				
US Federal Funds rate (average, %)	5.0	2.1	0.0	0.1
EU refinancing rate (average, %)	3.8	3.9	1.0	1.5
Japan overnight call rate (average, %)	0.5	0.5	0.1	0.3
Brent crude spot prices (average, $ per barrel)	72.6	97.3	43.0	50.0
Nonfuel commodity prices (% increase)	17.0	21.0	-32.2	6.5
CPI inflation (%, G3 average)	2.2	3.2	-0.3	1.2
World trade volume (% increase)	7.5	6.2	-3.5	1.9

[a] Average growth rates are weighted by GNI Atlas method.

Sources: US Bureau of Economic Analysis, available: www.bea.gov; Eurostat, available: http://europa.eu.int; Economic and Social Research Institute of Japan, available: www.esri.cao.go.jp; Consensus Forecasts; Bloomberg; United Nations, *World Economic Situation and Prospects 2009*, available: http://www.un.org/esa/; World Bank, *Commodity Price Data*, available: www.worldbank.org; staff estimates.

on-month, seasonally adjusted) in the last quarter of 2008, which in annualized terms was a drop of 8.3%. The fear that a deflationary spiral might occur was assuaged slightly in the first months of 2009. Prices edged up somewhat in January (0.3% over the previous month) and February (0.4%).

Energy prices had been largely responsible for the declines in earlier months. As oil prices began to stick at around $40–45 per barrel, the consumer price index (CPI) stopped falling. The forecast for CPI deflation in 2009 of 0.9% assumes that oil prices will stay flat and that weak demand and falling import prices will push the general level of consumer prices down a bit. The absence of inflation expectations removes an obstacle to further monetary easing by the Federal Reserve and provides room for aggressive quantitative easing to help shore up banks and provide the markets with liquidity.

Eurozone

Every major eurozone economy experienced contraction in GDP growth in the fourth quarter of 2008 relative to the third, with Italy, Germany, and France contracting year on year (by 2.6%, 1.6%, and 1.0%, respectively). The belated loosening by the ECB—compared with more aggressive Federal Reserve actions—and the reluctance of national governments to fund stimulus programs on a scale comparable to other OECD countries, points to the problem of coordinating rapid adjustments to macroeconomic policy across many member states. The fact that inflation has now dropped well within the 2% target range of the ECB (1.1% in January, 1.2% in February) indicates that more cuts in the policy rate may be forthcoming. The plunge in industrial production and the mounting problems in Greece, Ireland, and Spain may give a greater sense of urgency to both the ECB and finance ministers.

The eurozone in 2009 is projected to contract by 2.6% and show meager 0.5% growth in 2010. Collapsing exports, weak stimulus packages, and failing confidence as jobs are cut and markets continue to weaken are underlying reasons for the prolonged recession. Eurozone prices are expected to edge up in 2009 at 0.8% (CPI).

Crises and rising unemployment in economies that had shown rapid growth through 2007 are causing divisions among eurozone members on how to respond to the global crisis. Newer members of the European Union (EU) in Central and Eastern Europe are experiencing similar trauma as Ireland and Spain (in terms of bursting housing bubbles), but with serious external debt problems on top of domestic woes. Newer members such as Hungary and Romania used low-interest foreign-currency financing for real estate and construction booms that subsequently bust. These countries were preparing to join the eurozone, but such prospects have faded as the value of their currencies withered. Unemployment is on the rise and default on external debt appeared imminent, necessitating IMF support and associated austerity measures. Risks from resurgent economic nationalism and disproportionate burden-sharing between the older and newer member countries are firmly to the downside.

The difficulty in mustering the political will to bail out the weaker members is understandable given the policy errors that were made in funding domestic credit through foreign loans. Yet the financial position of the older member countries (apart from Italy) is relatively strong and the funding implications of bailouts for smaller members are not that severe. Hence, the depth and length of the downturn may be mitigated if the larger member states lead the recovery efforts.

Japan

Unlike the US and the eurozone, the monetary stance in Japan has been expansionary since the mid-1990s with a policy rate of less than 1%. Despite its limited monetary policy options, the Bank of Japan responded to the economic downturn by further lowering its target policy rate by 20 basis points to 0.3% at end-October 2008, and to 0.1% in mid-December.

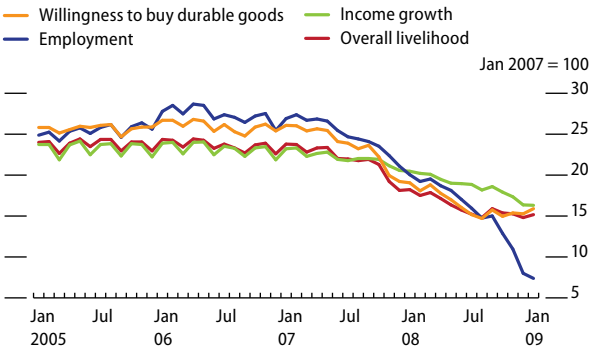
After the central bank took the unconventional measure of purchasing commercial paper, the heightened liquidity concerns seemed to have receded by the end of last year. Still, the CPI fell for 4 consecutive months to reach zero in January, and all corporate goods price indexes—including domestic, export, and import prices—already dipped into worrisome deflationary territory by January. Monetary policy is expected to remain extremely accommodative in 2009 and 2010.

The decline in consumer confidence seems to have bottomed out (Figure 1.2.2), but falling prices could reverse sentiment easily. Nonetheless, dismal indicators such as weak new-housing construction and machinery orders suggest continued weakness in private investment this year. Weak external and investment demand will likely outweigh any positive developments in 2009, and planned fiscal packages will not be sufficient to compensate the weak demand from other sources. Therefore, Japan is projected to contract by 3.5% in 2009, the largest rate among the G3, but to rebound in 2010, faster than the eurozone.

A recovery in 2010 is projected because the financial sector in Japan

is relatively healthy and adjustments in the corporate sector are making good progress. However, with economic activity largely reliant on external demand, prospects remain sensitive to the length and depth of the global slowdown. Another risk to the projections are the possible second-round impacts on the financial sector from increasing bankruptcy rates among smaller companies, which will burden banks with rising nonperforming loans.

1.2.2 Consumer confidence, Japan



Source: Economic and Social Research Institute, Cabinet Office, Government of Japan, available: http://www.esri.cao.go.jp/en, downloaded 12 March 2009.

Click here for figure data

Commodity price volatility

Plunging global demand and investors' flight to safety have felled most commodity prices (Figure 1.2.3). The IMF Commodity Price Index has fallen off its mid-2008 peak and is now (in the first 2 months of 2009) at levels not seen since early 2005. The generalized bubble nature of 2008 is clearly seen, but with differences among commodities. The gradual buildup of commodity prices over 2002–2006 that shot up before collapsing in mid-2008 is not well understood (Timmer 2008). A mix of factors appears to have led to the extraordinary volatility, including structural problems in supply and demand, unfavorable weather conditions, governments' short-run market interventions that triggered precautionary hoarding, and "hot money" seeking higher yields as a series of asset price bubbles imploded.

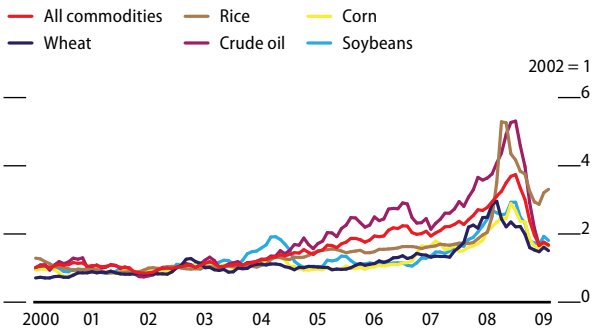
Crude petroleum prices have been the most volatile and are an important driver of other commodity prices. Most food products that either can be used to produce biofuels or as animal feed have followed these prices. Rice, however, is different. Rice prices, despite coming off their peak, are still elevated, posing severe hardships for the poorest in developing Asia.

Prices of precious metals, gold in particular, have revived in early 2009. The heightened precautionary demand for gold and other precious metals reflects the diminished confidence in financial markets.

Despite lower production by OPEC and a smaller than expected rise of non-OPEC output, the softening growth of demand from industrial and emerging market economies has put downward pressure on oil prices (Box 1.2.2). Recent price declines have stalled investment in new production and processing facilities, which will keep supply conditions tight once demand strengthens again. Assuming no significant political developments or disruptions on the supply side, the Brent crude oil price is projected to average $43 in 2009 and $50 in 2010. With an uncertain political situation in the Middle East, however, price volatility will continue with the risks biased toward higher than projected prices.

Nonfuel commodity prices have continued to ease in 2009 as a consequence of weakening global demand and improving supply conditions. In 2009, food prices are expected to decline closer to the level that was seen before the speculative boom in 2008 due to worsening demand and softening oil prices. However, prices will begin to turn around as global economies start to recover in 2010. Thus, nonfuel

1.2.3 Nominal commodity price movements



Notes: The commodity price index includes both fuel and nonfuel price indexes. The oil price index is the simple average of the spot prices of Dated Brent, West Texas Intermediate, and Dubai. The bases for the price of maize, rice, soybeans, and wheat, respectively, are as follows: U.S. No.2 Yellow, free on board Gulf of Mexico; Thailand white milled 5% broken, free on board Bangkok; U.S. No. 2 yellow, Chicago soybean futures contract (first contract forward); and No. 1 hard red winter, ordinary protein, free on board Gulf of Mexico.

Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 16 March 2009.

Click here for figure data

commodity prices are expected to decline by 32.2% in 2009, and rise to 6.5% in 2010.

Risks to the global outlook

If the crisis-resolution measures in the US and elsewhere turn out to be successful, growth may recover earlier than expected. Right now, however, the downside risks, discussed below, far outweigh the upside risks, and they could further worsen the already dismal global outlook.

Ineffective crisis-resolution and stimulus measures

Poorly designed and coordinated crisis-resolution measures could undermine the prospects for recovery in the industrial economies. The difficulties in credit markets may turn out to be deeper and take longer to resolve than expected. And first-round impacts of write-offs of on-balance-sheet valuation losses and concerns about the off-balance-sheet exposures of financial institutions still need to be resolved.

These risks also apply to institutions that are *not* "too big to fail." While the failure of such institutions does not pose a risk of systemic crisis, it would put further strains on the market. Success of recapitalization schemes and measures to clean banks' balance sheets remains key to re-instilling confidence in the banking system and to ensuring credit intermediation for a sustained recovery, particularly in the US and UK. Success of the programs, however, will rely on the size of liquidity injections, and the terms of the asset purchases, which are not yet clear. Prolonged stress on credit markets could further disrupt the real economy. Unless such risks are contained swiftly, the credit markets will continue to cast a shadow over global recovery prospects.

As conventional monetary policy using policy interest rate adjustments has reached its limits in many G3 economies, effective fiscal policies are vital to support aggregate demand. The sizable fiscal stimulus packages that have been announced so far appear appropriate given the depth of the downturn. However, much uncertainty surrounds the effectiveness of the fiscal measures in boosting flagging aggregate demand and growth. Further, the swelling public spending could raise the public debt to unsustainable levels, thus creating future fiscal risks. Unless the fiscal packages are well targeted and implemented in a timely manner, the effectiveness of fiscal policy will suffer and the prospects for a G3 recovery to begin in 2010 will need to be revisited.

Emerging protectionism

A major additional risk to the global outlook is protectionist policies. These would further crimp global trade and so exacerbate the global downturn. The political temptation to protect domestic firms and jobs by erecting trade barriers is likely to grow. Worryingly, most of the world's major economies have already begun to resort to various forms of protectionism.

A concrete example is the huge volumes of aid being doled out to automobile manufacturers around the world. The risk of protectionism is especially relevant for trade-dependent developing Asia.

1.2.2 Recent global oil price trends and their implications for developing Asia

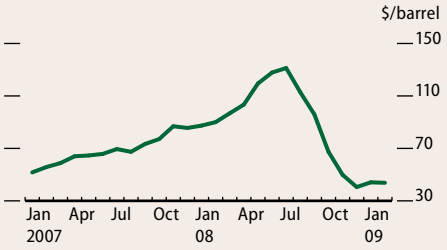
The one bright spot in the external environment is the sharp decline in global oil prices since the third quarter of 2008. Because developing Asia is a large net importer of oil, it stands to reap sizable terms-of-trade benefits from softening oil prices. Their easing will give regional central banks greater scope for expansionary monetary policies.

This box offers a brief analysis of recent oil-price trends, the main drivers behind those trends, and the likely trajectory of oil prices in the medium term, as well as policy implications.

Drivers behind recent price trends

The global oil market has witnessed an astonishing turnaround since oil prices hit their peak in July 2008. That peak marked the culmination of an unprecedented escalation of oil prices from about $50 per barrel in January 2007 (Box figure 1). During the runup, there were mounting concerns across the region about the adverse effects of higher oil prices on inflation and growth. (*ADO 2008 Update* took an in-depth look at higher oil prices and their implications for the region.) Yet it took only 4 months to wipe out the $100 per barrel increase that was made in 4 years.

1 Dubai crude oil price



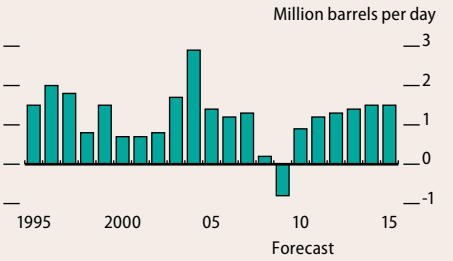
Source: FACTS Global Energy Group, *Oil Price Outlook: Updated Analysis of Critical Factors Driving the Oil Market*, March 2009.

Click here for figure data

The collapse of the global oil market is being driven by a collapse of global demand. Global oil demand tends to grow even during economic downturns and a decline in demand is rare (Box figure 2). Yet global demand fell sharply by 1.7 million barrels per day (bpd) in the fourth quarter of 2008 and is projected to contract for 2009 as a whole.

The deep and broad global downturn is taking a heavy toll on oil exporters. The first signs of demand weakness emerged in the Organisation for Economic Co-operation and Development (OECD) economies. Asian demand growth has been a key driver of the global oil market during the past decade, typically accounting for 40–50% of the annual increase in global demand. Indeed, explosive demand growth in Asia during 2003–2004 set the stage for the 4-year runup. The region's demand held up well in the first half of 2008, but has since tumbled.

2 Global incremental oil demand



Source: FACTS Global Energy Group, *Oil Price Outlook: Updated Analysis of Critical Factors Driving the Oil Market*, March 2009.

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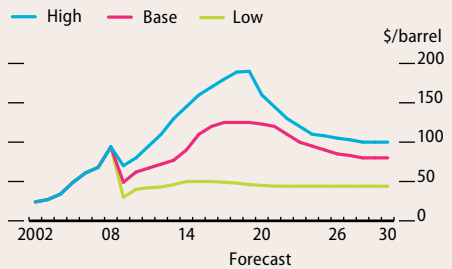
Demand will continue to overshadow supply as the primary driver of oil prices in the short term. Oil prices are expected to remain subdued in 2009. Global demand is projected to decline by as much as 2 million bpd during the first half, a very significant fall in the finely balanced global oil market. Asian demand is projected to contract by about 400,000 bpd in 2009, a sharp drop from its "normal" growth of 600,000–800,000 bpd. Due to OPEC's reduction of its output target, prices have recently stabilized at around $40–45 per barrel. This is likely to remain the price range during the first half, when prices will bottom out before inching higher in the second half, in tandem with the global business cycle.

For 2009 as a whole, the projected price of a barrel of Dubai crude is about $48.50, well below the 2008 price of $93.80 (Box figure 3). The more robust global recovery expected in 2010 will push up prices to about $62.30 in 2010. Given the close link between global GDP growth and oil demand, the main source of uncertainty surrounding the short-term price outlook is the scale and speed of global recovery. The fact that OPEC now has substantial spare capacity can help stabilize prices in the event of supply shocks.

Global oil prices are determined by a combination of supply- and demand-side factors. Some of those factors are structural, others cyclical. The predominant role of

3 Forecasts for Dubai crude oil



Source: FACTS Global Energy Group, *Oil Price Outlook: Updated Analysis of Critical Factors Driving the Oil Market*, March 2009.

Click here for figure data

1.2.2 Recent global oil price trends and their implications for developing Asia *(continued)*

cyclical demand in the current market simply reflects the unprecedented severity of the global slowdown. However, it is highly improbable that the softness of oil prices will be more than a temporary blip over a longer term.

Medium-term price trajectory

Beyond the short term, structural supply- and demand-side factors are likely to reassert themselves with full force and to determine prices. The global economic downturn, despite its huge impact in the short term, has done nothing to alter the basic medium- to long-tem calculus of oil prices—the failure of supply to keep pace with fast-growing demand, especially from developing countries.

On the supply side, the global crisis is likely to have delayed some investment. Non-OPEC oil production is expected to peak in 2012–2013, and in addition beyond 2015, OPEC is unlikely to invest sufficiently in extra production capacity.

On the demand side, fast-growing developing countries such as the People's Republic of China will continue to experience rapid structural growth in demand for oil. In addition to the general impact of rising incomes, the demand for transportation fuel is set to surge as car ownership expands. These medium- to long-term supply- and demand-side fundamentals imply the type of price trajectory envisaged in Box figure 3.

In the base-case scenario, which reflects the most likely supply and demand scenarios over time, prices are projected to gradually increase until the end of the next decade before easing gradually toward the long-run marginal cost of alternative fuels. Revealingly, the New York Mercantile Exchange futures market also points to a tighter oil market in the future (Box figure 4). The differential between spot prices and 5-year-ahead prices is about $25 per barrel, which is very large in historical terms. The differential reflects a market consensus about the persistence of supply constraints, which will have a bigger effect on prices when demand conditions return to normal.

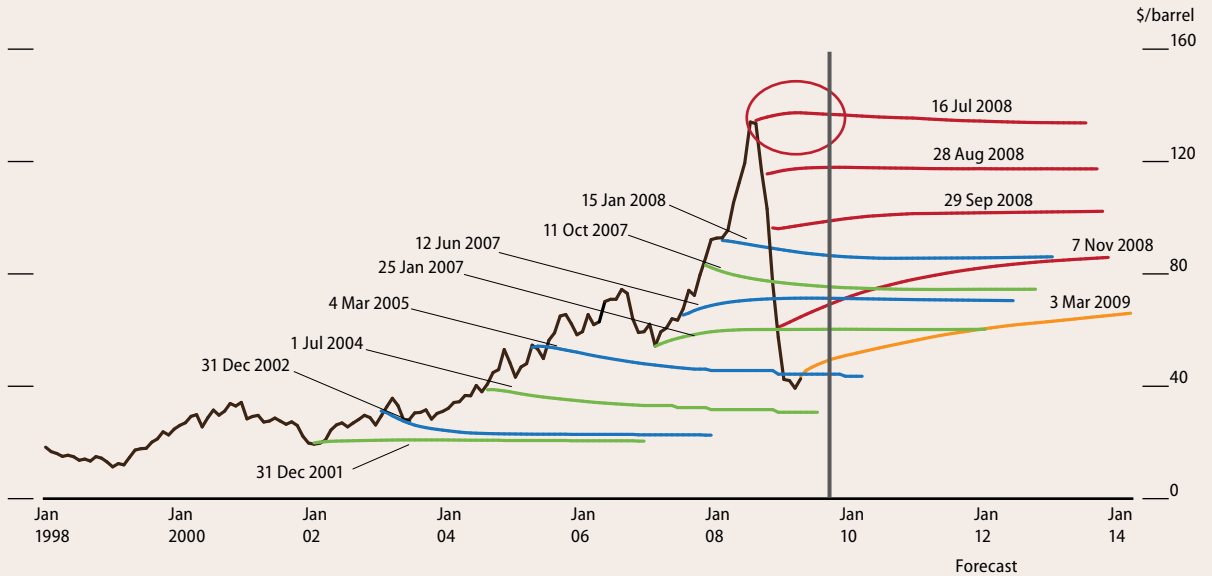
Policy implications

The global economic crisis has bought some time for policy makers to prepare for the next period of high oil prices. It is imperative that they maintain the sense of urgency they had when prices peaked last July. In light of longer-term price projections, the policy recommendations in *ADO 2008 Update* remain unchanged. In particular, Asian governments should pursue policies that encourage efficient oil use, minimize short-term supply disruptions, and encourage price transparency. However, the fall in oil prices adds a couple of new twists.

First, lower global prices provide an opportunity to eliminate oil-product price subsidies, which encourage inefficient oil use, while inflicting minimal pain on consumers. Second, eliminating oil subsidies is also a critical first step in creating a market environment that is conducive for alternative fuels. Over a longer period, tax policies that more accurately reflect the true cost of consuming oil products will encourage alternative fuels.

Source: This box draws on a background paper prepared by Jeff Brown, FACTS Global Energy Group, March 2009.

4 West Texas Intermediate—NYMEX futures prices



Note: The line being referred to by a particular date is its forward curve.

Source: FACTS Global Energy Group, *Oil Price Outlook: Updated Analysis of Critical Factors Driving the Oil Market*, March 2009.

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Oil-price volatility

Oil prices are likely to stay volatile. Although prices dropped substantially after reaching a peak above $140 in mid-2008, uncertain market conditions, speculative demand, and political risk can always cause prices to fluctuate widely. The deepening global slowdown is tempering demand for oil, but tensions in the Middle East raise questions about supply. However, if growth rates in major industrial economies start to rebound in 2010, upward pressure on oil prices is likely.

Deflation

Despite aggressive monetary easing in the G3, softening aggregate demand and lower commodity and asset prices have put downward pressure on consumer prices. As such, the risk of deflation cannot be discounted. Yet, the expansionary monetary policy stances of many central banks are reaching their limits, leaving them with limited options for fighting deflation if it materializes. Deflation would hinder global recovery by discouraging consumer spending (due to expectations of lower prices) as well as new investment (due to positive real interest rates). An additional potential cost of deflation is further deterioration of labor markets. Downward adjustment of nominal wages is difficult to achieve, and this would saddle an already grim labor market with higher unemployment rates.

Social instability

The global downturn is seriously affecting employment throughout the G3. The effects are likely to be disproportionately borne by unskilled and semiskilled workers, which will contribute to inequality and marginalization. Migrant workers in particular are vulnerable to the loss of jobs in host countries. If the recovery is delayed, the growing pool of disaffected unemployed people may undermine social cohesion and could even fan anti-immigrant sentiments. Industrial-country governments' desire to ensure employment and stability at home may also heighten calls for trade protectionism. Yet any short-run stability gains of such measures would only further delay recovery.

Developing Asia: Outlook amid crisis

The financial sectors of developing Asia's economies have so far weathered the crisis quite well. Bank credit continues to flow normally to the real sector, even though access to credit has tightened for riskier borrowers. Financial institutions' limited exposure to subprime assets and improved fundamentals since the 1997–98 Asian financial crisis explain the resilience to the global credit crunch.

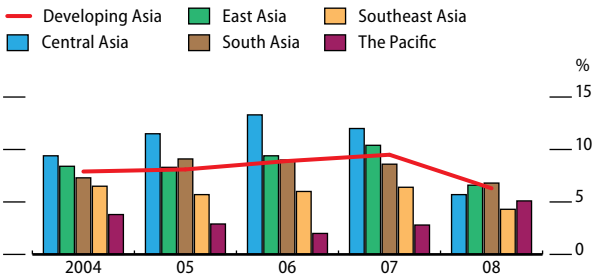
Nonetheless, the effects of the global crisis are being felt in the region. Developing Asia's economic growth in 2009 will slow to its most sluggish pace since the 1997–98 Asian financial crisis. The global downturn is having a pronounced impact on the region's exports, and subdued domestic demand will further crimp growth. A regional recovery will have to wait until 2010 when it is forecast that the world economy will improve.

Recent trends

Growth in 2008 decelerated across developing Asia with only the Pacific islands performing better than in 2007. Growth fell by one third from a peak of 9.5% in 2007 to 6.3% in 2008 (Figure 1.3.1).

Expansion in East Asia slowed to 6.6%, from a rapid 10.4% in 2007, as all five economies in this subregion decelerated. Weaker growth in manufactured exports was a major factor. Southeast Asia's growth eased to 4.3%, from 6.4% in 2007, with all the economies in this subregion slowing. The highly trade-dependent countries were hit the hardest.

1.3.1 GDP growth, developing Asia



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

In South Asia, growth moderated to 6.8% from 8.6% in 2007. India's growth slowed over the course of 2008, coming in at an estimated 7.1% for the year, well below the 9% of recent years. The global financial turmoil and deteriorating economic outlook heavily damped capital inflows and led to marked falls in business and consumer confidence.

In Central Asia, growth in 2008 plummeted to 5.7% from 12% with most countries experiencing a downdraft. In Kazakhstan, limited access to global capital markets virtually halted domestic bank lending, cutting growth to only 3.2%.

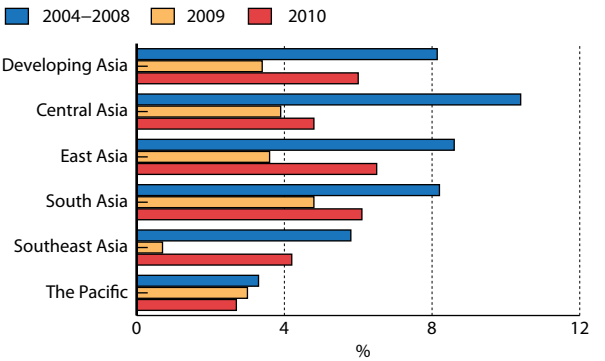
Regional inflation spiked to 6.9% in 2008 as global food and oil prices escalated in the first half of the year, but slower demand and the drop in commodity prices in the second half helped keep annual inflation in check. Aggregate inflation quickened in East Asia, but at 5.4% remained the lowest of all the subregions. In contrast, inflation in Southeast Asia more than doubled to 8.8%.

Outlook

Deteriorating global prospects have soured the outlook for developing Asia in the next two years. GDP growth is projected to reach only 3.4% in 2009, which is nearly 3 percentage points slower than the 2008 rate, with every subregion hit. On the assumption that the global economy makes a mild recovery in late 2010, regional growth is projected to improve to 6.0% next year. Thus growth over the next 2 years is likely to stay well below the recent historical trend (Figure 1.3.2)

The drop in demand accompanying the global slowdown and the fall in commodity prices have eased inflation pressures in developing Asia. Prices are expected to rise by 2.4% in 2009, considerably below 2008's 6.9% (Figure 1.3.3). Inflation should stay largely in check in 2010 with the rate projected to continue at 2.4%, even with the anticipated G3 recovery late in the year.

1.3.2 Five-year average and forecasts of GDP growth, developing Asia

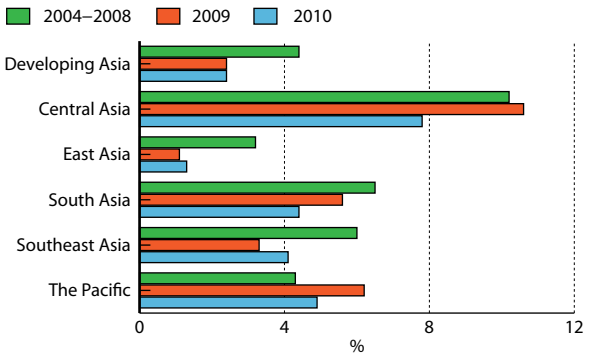


Sources: Asian Development Outlook database; staff estimates.
Click here for figure data

Growth in East Asia is forecast to decelerate to 3.6% in 2009, pulled down by declines in exports of manufactures and knock-on effects on incomes and investment. While the PRC is expected to expand by 7.0%, Hong Kong, China; Korea; and Taipei,China will contract. Inflation is expected to average less than 2%, except in Mongolia where it will ease but still be much higher than elsewhere in the subregion. Most subregional economies will record current account surpluses. In 2010, subregional GDP growth is forecast to bounce back to 6.5% as global trade picks up and stimulus packages have a positive impact.

Growth in the PRC is seen slowing to 7.0% this year, as exports decline and private investment subsides. Private consumption, though, is expected to remain relatively buoyant. Both public consumption and investment will be bolstered by the fiscal stimulus measures being rolled out. Inflation is expected to average less than 1%. The current account surplus, while narrowing slightly, will be substantial. GDP growth in 2010 is projected to pick up to about 8%.

1.3.3 Five-year average and forecasts of inflation, developing Asia



Sources: Asian Development Outlook database; staff estimates.
Click here for figure data

Southeast Asia's growth is projected to dwindle to just below 1% this year, with output contracting in the highly trade-exposed countries of Malaysia, Singapore, and Thailand. Inflation will decelerate to about 3%, less than half the 2008 rate. In aggregate, the current account surplus will decline, but some of the bigger economies are expected to record surpluses. Next year, all these economies are expected to rebound and record moderately high growth.

Growth in South Asia is expected to slow in 2009. India will likely see only a 5% expansion, while Maldives, Pakistan, and Sri Lanka are expected to experience a marked slowing. With little room for fiscal stimulus, these four countries need to rely on monetary and structural policies to mitigate the headwinds from the global economic downturn.

While not highly open, the economies of South Asia are still vulnerable to balance-of-payments pressures. Bangladesh, Nepal, Pakistan, and Sri Lanka all rely heavily on workers' remittances to offset large trade deficits, and their exports are concentrated in textiles and clothing. Both these sources of foreign exchange showed signs of weakening in 2008 and may emerge as constraints in the period ahead.

In Central Asia, growth is expected to decelerate further to just 3.9% in 2009 and to less than 5% in 2010. This is mainly due to a further slowing in Kazakhstan to only 2% this year as it continues to grapple with its banking system problems. Growth is expected to fall to low levels in all the non-oil-producing countries as the full impact of the global economic slowdown is felt in the Russian Federation, the subregion's main trade and financial partner.

With slower economic expansion and weaker commodity prices, inflation is expected to moderate in Central Asia. The major macroeconomic challenge in 2009–2010 is keeping the balance-of-payments strains from reaching levels that would threaten growth in Armenia, Georgia, Kyrgyz Republic, and Tajikistan. These countries rely heavily on remittances from workers in the Russian Federation and Kazakhstan and these may well be curtailed by more than is now expected. Moreover, the adequacy of capital inflows is also at risk in light of the global credit crunch.

Aggregate growth in the Pacific is anticipated to decelerate to 3% in 2009, largely because Papua New Guinea's expansion will abate after 2 years of strong growth driven by the commodity boom. Fiji Islands is expected to slip back into contraction, hurt by the negative impact of the global slowdown on tourism and remittances as well as by severe flooding in early 2009. Inflation is expected to ease in all of the countries. Subregional growth is projected to remain close to 2009 levels next year.

Developing Asia and the global crisis: Channels of contagion

This section explores the impacts of the crisis on developing Asia's economies with a focus on financial markets and the real economy, including international trade flows, investment flows and domestic incomes, employment, and consumption demand.

Impact on developing Asia's financial stability

The current global economic slowdown is having a pronounced adverse impact on the real economies of developing Asia. GDP growth is set to decelerate throughout the region as a result of softening demand for the region's exports. In view of this stark reality, the policy makers and public of the region are largely preoccupied with the real economy. However, the global downturn is rooted in a global financial crisis, which, in turn, originated in the US subprime mortgage crisis. The financial crisis has already spread across the Atlantic to many European countries. As a result, both the US and EU are suffering a severe credit crunch. Therefore, an issue of utmost importance for developing Asia is the extent to which the global financial crisis has affected its financial stability, a point addressed in this subsection.

So far Asian financial institutions and financial systems as a whole seem to have been largely unscathed by the global financial crisis. In particular, the region has thus far averted the severe financial turbulence gripping the US and EU. By and large the empirical evidence, which will be presented and discussed below, justifies optimism.

A major underlying reason for Asia's relative immunity is that the region's financial institutions, unlike their counterparts in the US and Europe, have only limited exposure to subprime and related products—the "toxic assets." Nevertheless, the global financial crisis is far from over, and the speed and scale of its resolution remain subject to much uncertainty. The biggest risk to the region's continuing financial stability is the specter of a deep and protracted downturn. Corporations might then experience losses that would make it difficult for them to repay their loans and this would undermine the balance sheets of the region's commercial banks and other financial institutions.

Limited financial crisis impacts

Despite the rapid development of capital markets in recent years, Asian financial systems are still dominated by commercial banks. For this reason, one must consider the issue of bank credit up front when evaluating the impact of the global financial turmoil on regional financial systems. That is, has the crisis notably disrupted the flow of bank credit to firms and households?

Encouragingly, the balance of evidence suggests that bank credit continues to flow to the real sector in much of the region (Table 1.4.1).

1.4.1 Growth of private domestic credit in selected Asian economies (%, year on year)

	2006	2007	2008 Q1	2008 Q2	2008 Q3	2008 Q4
China, People's Rep. of	12.1	18.0	19.1	16.9	14.8	13.2
Hong Kong, China	4.3	7.6	9.6	14.6	18.3	0.6[a]
India	28.1	22.8	22.4	24.2	24.8	27.8[a]
Indonesia	13.9	18.9	27.4	31.5	34.2	36.5
Korea, Rep. of	10.8	14.3	14.3	16.0	16.2	16.4[b]
Malaysia	8.6	9.0	10.9	10.8	9.7	9.5[a]
Philippines	1.2	5.9	8.4	8.9	16.9	16.5
Singapore	3.6	10.2	18.5	20.5	20.7	17.5
Thailand	6.4	3.3	5.4	6.8	9.5	9.7

[a] October and November 2008. [b] October 2008. [c] Shading indicates a deterioration.

Sources: CEIC Data Company, Ltd.; International Monetary Fund, *International Financial Statistics* online database; both downloaded 11 March 2009.

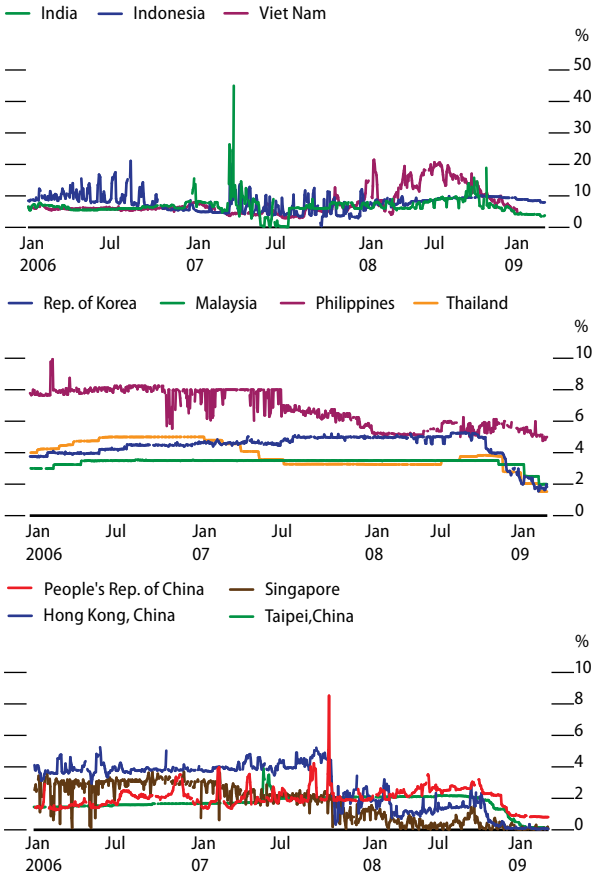
While there have been some signs of stress in the credit markets, these have been relatively minor. "Credit hiccup" rather than "credit crunch" may be a more accurate term to describe the market conditions in those instances. Despite some tightening, the credit markets continue to function more or less normally and, unlike the US and UK, credit constraints have not hit the real economy with full force. Indeed, the bigger concern is that the slowing economy will significantly reduce the demand for loans as firms and consumers cut back investment and consumption.

Nevertheless, anecdotal evidence from throughout the region suggests that banks have pulled back from lending to riskier borrowers. For example in Korea, there is a large gulf between the ability of larger firms, on the one hand, and small and medium-sized enterprises, on the other, to obtain external financing, even though overall credit conditions have eased. In Singapore the Government, recognizing the tightening of credit lines for smaller firms, has committed itself to facilitating loans to them and to bearing a high share of the risk associated with those loans. However, the overall picture in the region's credit markets is one of minor and sporadic disruptions.

Further evidence of the good health of Asian banks comes from the interbank market. Banks deal extensively with each other and generally have accurate information on each other. The interbank interest rate refers to the interest rate that one bank charges another for loans, and it provides information about the assessment of one bank's health by other banks.

For example, an increase in the interbank interest rate at which Bank B can borrow suggests deterioration in other banks' perception of Bank B's health. While interbank interest rates for individual banks would help identify problem banks, such data are very difficult to obtain. Nevertheless, data are available for the market average of interbank interest rates (Figure 1.4.1). Although Asian interbank markets are still thin and somewhat underdeveloped (except for Hong Kong, China; and Singapore), such data give information about the cost of interbank borrowing for the banking system as a whole.

1.4.1 Interbank rates



Source: CEIC Data Company Ltd., downloaded 16 March 2009.

Click here for figure data

Despite the sporadic and intermittent episodes of extreme market pressures in Asian money markets, interbank rates have generally remained at or below precrisis levels after spiking after the collapse of Lehman Brothers last September. This could partly be due to liquidity injections by central banks and the relatively minor role of interbank borrowing as a source of funding, but more fundamentally, it reflects the fact that in Asia the global credit crisis has not disrupted the flow of short-term credit, either among banks or to the real economy. Figure 1.4.1 in fact shows that interbank interest rates have been falling in the early part of 2009 since peaking in the third or fourth quarter of last year. This provides yet more reason for optimism about the relative soundness of the regional banking system.

The immediate catalyst of the US subprime crisis was the decline in US housing prices. The overall trend of Asian housing market price indexes suggests that regional housing prices have not experienced the sharp declines seen in the US or EU. The declines that have occurred have been moderate and are nowhere near as pronounced as those in the region's equity markets. Intuitively, property prices are determined by local conditions and there is much less scope for contagious effects from industrial-country markets. Looking ahead however, the ongoing slowdown in the region's real economy could strain its housing markets.

Negligible toxic asset exposure

Considering that developing Asia's financial systems, in particular its core commercial banking system, have been largely immune to the global financial turmoil so far, the key question then becomes: Why?

The most immediate reason is the region's limited exposure to subprime assets, which initially precipitated the current crisis. According to the estimates of Kawai et al. (2008), the direct exposure of Asian financial institutions to subprime products such as mortgage-backed securities and collateralized debt obligations is, in fact, minimal. Consequently, the estimated losses arising from subprime assets are similarly minimal relative to the size of bank capital and assets (Table 1.4.2). As of May 2008, total reported writedown and credit losses of the world's 100 biggest banks and securities companies amounted to $379 billion. Of these, Asia excluding Japan accounted for $10.8 billion, which is less than 3% of global losses.

This generally benign picture must be qualified though, because many regional banks are less than fully transparent about the composition of their overseas assets and the valuation of complex subprime-related derivatives on their balance sheets. With this in mind, the conventional wisdom that Asia's direct exposure is much less than that of the US or Europe is strongly borne out by the empirical evidence.

Even though direct exposure to toxic assets is minimal, developing Asia may suffer indirectly in a big way if regional banks have sizable exposure to the major US and European financial firms holding significant amounts of such assets. This risk is material since many of the US and European firms that have been hit by the crisis are large, well-established multinationals with extensive business transactions with Asian banks. In particular, Asian banks that have bought bonds or equities in the infected Western financial institutions are likely to share

1.4.2 Asia's subprime losses

	United States	Japan	Korea, Rep. of	China, People's Rep. of	Malaysia	Total Asia
Subprime losses ($ billion)	157.7	8.7	0.4	2.8	0.1	19.5
Total bank assets ($ billion)	15,492	11,350	1,184	5,950	267	20,965
Capital of banks ($ billion)	1,572	572	85	256	29	998
Subprime losses as share of capital (%)	10.03	1.52	0.52	1.08	0.30	1.95
Subprime losses as share of assets (%)	1.02	0.08	0.04	0.05	0.03	0.09

Notes:

Capital of banks: "capital account" item in International Financial Statistics as of December 2007.

Total bank assets as of December 2007 for the United States and Malaysia; as of January 2008 for Japan, Korea, and People's Republic of China.

Total Asia includes data on other commercial banks in Asia.

Japan: Mizuho Financial Group and Nomura Holdings.

Korea, Rep. of: Woori Bank.

China, People's Rep. of: Bank of China, Commercial Bank of China, China Construction Bank.

Malaysia: 0.3% of capital base of banks.

United States: 14 banks.

Source: M. Kawai, M. Lamberte, and D.Y. Yang. 2008. "Global Shocks, Capital Flows and Asian Regional Economic Cooperation." Asian Development Bank Institute, Tokyo.

in the losses suffered by those institutions. The larger the direct losses incurred by the holders of toxic assets, the larger the indirect losses of Asian investors. However, as with direct losses, the Asian banks' indirect losses seem to have been quite small. For example, the exposure of Asian banks to Lehman Brothers, the big US investment bank that collapsed in September 2008 as a result of the subprime crisis, has been limited (Table 1.4.3).

One important qualification to this upbeat assessment is that nonbank financial institutions, such as sovereign wealth funds, may have suffered heavy losses on their investments in Western banks. This is widely believed to have been the case for Singapore's GIC and Temasek.

Improved sector fundamentals

In addition to the limited direct and indirect exposure to subprime assets, the second major reason why developing Asia's banking system has been largely immune to the global financial turmoil so far is that the system's fundamentals were relatively strong when the subprime crisis broke out

1.4.3 Selected Asian banks with exposure to Lehman Brothers bank, September 2008

Bank name	Economy	Exposure ($ million)
Citibank (Hong Kong, China branch)	Hong Kong, China	275
Mega Financial	Taipei,China	200
Industrial and Commercial Bank of China	People's Rep. of China,	152
Banco de Oro	Philippines	134
Bank of China	People's Rep. of China	129
Bangkok Bank	Thailand	101
Bank of Nova Scotia (Singapore branch)	Singapore	93
Shin Kong Fin	Taipei,China	80
Development Bank of the Philippines	Philippines	90
Metropolitan Bank and Trust Company	Philippines	71

Source: Reuters, available: http://uk.reuters.com/article/governmentFilingsNews/idUKMAN20091320080925, downloaded 26 September 2008.

in the third quarter of 2007. At that time, all the key financial soundness indicators—nonperforming loans as a share of total commercial bank loans, risk-weighted capital-adequacy ratios, and rate of return on commercial bank assets—all told the same, upbeat story (Table 1.4.4).

Although there are differences across countries, the overall trend is one of systematic improvement in the health of the region's banking system as a result of extensive restructuring and reform since the Asian crisis. The incidence of nonperforming loans came down and the rate of return on bank assets went up throughout the region between 1999 and 2007 or 2008. Although the risk-weighted capital-adequacy ratio declined in some countries, this reflects the extreme conservatism of banks and hence unusually high ratios in the immediate aftermath of the Asian crisis. The ratios prevailing in the region in 2007 or 2008 were above the global norms for capital adequacy. Asian banks' strong fundamentals have helped them weather the storm of the global crisis reasonably well.

Current areas of concern

Although the region's financial systems are in good overall shape, there are some areas of concern. Equity prices have collapsed and access to external financing has tightened.

Equity price collapse

The banking sector lies at the very core of Asian financial systems and has been unscathed so far, but it is unrealistic to expect these systems to be completely immune to the unprecedented global financial crisis.

1.4.4 Financial soundness indicators

	Nonperforming loans (% of bank loans)		Risk-weighted capital-adequacy ratio		Banks' return on assets	
Developing Asia	1999	2007 or 2008	1999	2007 or 2008	1999	2007 or 2008
China, People's Rep. of	-	6.7	12.8	7.7	0.1	1.0
Hong Kong, China	7.2	1.2	18.7	14.3	0.4	2.0
India	14.7	2.4	11.2	12.6	0.5	1.0
Indonesia	32.9	8.5	-6.7	16.8	-8.7	2.3
Korea, Rep. of	8.3	0.8	10.8	12.0	-1.3	0.9
Malaysia	11.0	2.2	12.5	12.6	0.7	1.5
Philippines	13.6	3.9	17.5	15.9	0.4	1.4
Singapore	5.3	1.8	20.6	14.0	1.2	1.4
Thailand	38.6	5.3	12.4	14.8	-5.7	0.1
Other						
Japan	5.8	1.5	11.9	12.3	-0.9	0.3
United States	2.2	5.1	12.2	12.8	1.3	0.6

Notes:

For nonperforming loans, latest data are December 2007 for People's Rep. of China; September 2008 for Rep. of Korea and Japan; November 2008 for Philippines; March 2008 for Indonesia; September 2007 for Singapore; and December 2008 for Hong Kong, China; India; Malaysia; Thailand; and United States.

For capital-adequacy ratio, latest data are June 2007 for People's Rep. of China; March 2008 for Hong Kong, China; India; Japan; Rep. of Korea; and United States; December 2008 for Indonesia and Malaysia; September 2007 for Philippines and Singapore; and December 2007 for Thailand.

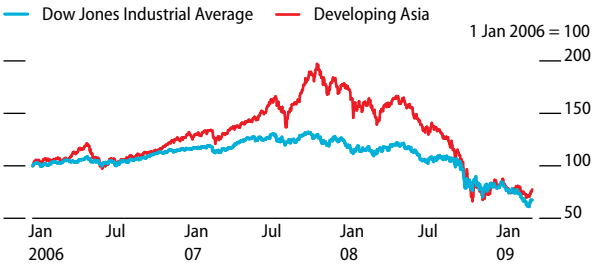
For return on bank assets, latest data are June 2007 for People's Rep. of China; March 2008 for Hong Kong, China; India; Japan; Rep. of Korea; and United States; December 2008 for Indonesia; December 2007 for Malaysia, Philippines, and Thailand; and September 2007 for Singapore.

Sources: CEIC Data Company, Ltd., downloaded 11 March 2009; International Monetary Fund. *Global Financial Stability Report 2008 and 2004*. Washington, DC.

In fact, two areas—equity markets and access to external finance—have come under pressure.

Share prices have tumbled since the fourth quarter of 2007 (Figure 1.4.2). The rout has been driven by mounting concerns over the deteriorating global economic outlook. For a region that still depends heavily on G3 exports for growth, the synchronized G3 recession will have a tangible impact on corporate performance and earnings. The equity plunge also reflects growing uncertainty over global financial stability as the global financial crisis continues to unfold. The loss of investor confidence in Asian equity markets closely mirrors that of the US, and the two markets have moved similarly since August 2007.

1.4.2 Equity prices



Note: Prices for developing Asia are taken from the Morgan Stanley Capital International All Asia excluding Japan index. It covers People's Rep. of China; Hong Kong, China; India; Indonesia; Rep. of Korea; Malaysia; Philippines; Singapore; Taipei,China; and Thailand.

Source: Bloomberg, downloaded 16 March 2009.

Click here for figure data

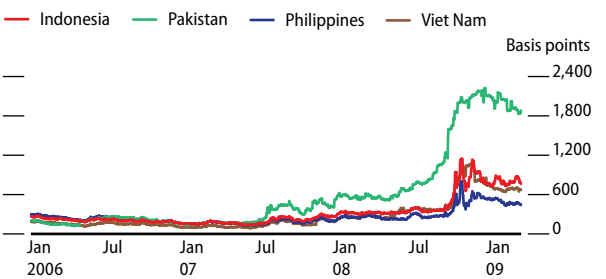
Slumping stock prices could influence bank lending in the region through various channels. First, they in effect raise the cost of capital for firms and thus make it more difficult for them to finance new investments. This exacerbates the slowdown in economic activity, which reduces bank lending and income. In addition, the negative wealth effect due to falling stock prices curtails household consumption. However, both effects are known to materialize only after a lag and their magnitude is uncertain.

Falling stock markets may put a damper on business and consumer confidence, which may further slow economic activity and banking business. Stock market slumps may also have a significant negative effect on banks' balance sheets, especially for banks with substantial exposure to equities. The balance sheet risks are magnified if the equities have been purchased through leveraging. However, in developing Asia the balance sheet risks to banks arising from stock market corrections are relatively small and it is the property market that probably poses a bigger threat.

Tightness of external financing

The second major area of concern is access to external finance, which has dried up as investors from industrial countries pull back from developing countries in order to bolster their balance sheets at home. This tightness has become a serious problem in some countries, most notably Pakistan, which has had to turn to an IMF rescue package.

1.4.3 JP Morgan EMBI stripped spreads



EMBI = Emerging Markets Bond Index.

Source: Bloomberg, downloaded 16 March 2009.

Click here for figure data

One specific example of tighter external finance is the sharp rise in the risk premium on dollar-denominated offshore bonds of Asian issuers (Figure 1.4.3). This increase in yield is part of a trend toward repricing risk in international dollar bond markets. This trend is, in turn, part of a broader widening of spreads on high-risk borrowers. The deterioration of investor confidence has been especially evident for Indonesia, Pakistan, Philippines, and Viet Nam, but other countries have also suffered. Unsurprisingly, the widening of credit spreads has curtailed issuance of new bonds in the region.

Such tightening of financing conditions has not yet spilled over into local currency bond markets, except in Indonesia. According to Adams (2008), the limited spillover reflects relatively little switching of funding between the dollar and local currency bond markets. In addition, dollar

bonds remain by and large a minor source of funding for firms in the region.

If Asian banks rely on foreign borrowing to finance their loans, the seizing up of credit markets in the US and EU can spread to Asia. A key indicator in this context is the ratio of loans to domestic deposits in the banking system (Table 1.4.5). If this ratio is less than one, domestic deposits are sufficient to fund the banking system's loans; if it is more than one, the banking system has to borrow from domestic and foreign sources. If foreign borrowing accounts for a substantial share of total borrowing, the credit crunch currently gripping the US and EU can cause liquidity problems for Asian banks.

The only major Asian country where the loan-to-deposit ratio is high enough to cause some concern is Korea, which has indeed experienced some financial instability, especially evident in the foreign exchange markets. A further factor for Korea is its exceptionally open capital account. The huge withdrawal of foreign funds from the equity market has played a major role in exchange rate turbulence. Nevertheless, strong policy measures by the Government, most notably currency swaps by the Bank of Korea with the US Federal Reserve and with the PRC and Japanese central banks, have restored a measure of stability to Korea's financial markets.

Risks to future financial stability

In the short to medium term, an important variable that will determine whether Asian financial systems will continue to be relatively stable is the depth and length of the economic slowdown. The balance sheets of Asian banks have benefited both from the region's strong macroeconomic performance during the past few years, and from post–Asian crisis

1.4.5 Bank ratios, Q4 2008

	Loans to domestic deposits	Loans to total liabilities	Foreign liabilities to domestic deposits
China, People's Rep. of	0.69	0.68	0.01
Hong Kong, China	0.50	0.28	0.78
India	0.79	0.78	-
Indonesia	0.80	0.75	0.07
Korea, Rep of.	1.36	1.05	0.30
Malaysia	0.96	0.86	0.11
Philippines	0.78	0.69	0.14
Singapore	0.85	0.51	0.66
Taipei,China	0.77	0.71	0.08
Thailand	0.98	0.94	0.04
Viet Nam	0.98	0.91	0.07

- = data not available.

Notes:

Data for the People's Republic of China; Hong Kong, China; Indonesia; Malaysia; Thailand; and Viet Nam are based on banking institutions from *International Financial Statistics*.

Data for the Republic of Korea and Singapore are based on deposit money banks from *International Financial Statistics*.

Data for Taipei,China are based on deposit money banks; for the Philippines from the survey of depository corporations; and for India from the commercial bank survey reported in the CEIC.

Data for Hong Kong, China and for Malaysia are as of November 2008; those for the Republic of Korea and Viet Nam are as of October 2008.

Sources: Staff calculations based on data from CEIC Data Company, Ltd.; International Monetary Fund, *International Financial Statistics* online database; both downloaded 11 March 2009.

1.4.4 Overall index versus financial stocks index, selected Asian economies

Source: Bloomberg, downloaded 16 March 2009. *Click here for figure data*

restructuring and reform. The benign global outlook prior to the current crisis enabled robust economic activity throughout the region.

A severe and extended global slowdown will have a substantial adverse impact on the region's growth, and will reduce the earnings and profits of Asian banks. In particular, higher corporate and individual bankruptcies will increase nonperforming loans, forcing banks to set aside funds to cover them. The sharp fall in financial-sector equity prices over the past few months (closely mirroring the fall in overall equity prices) (Figure 1.4.4), implies that the main risk for Asian banks will be the softening of Asia's hitherto vibrant real economies.

An additional risk arises from potentially ineffective crisis resolution in the US and EU. Other than the primary risk of an extended real-economy slowdown, a prolonged and disorderly resolution of the credit crisis there is bound to have adverse repercussions for Asia's financial stability. The curtailment of capital outflows from the major industrial countries will further restrict the region's access to external finance.

More generally, just as the region's real economies are dependent on the world economy, adverse financial developments outside the region will harm the region's financial stability. For example, recent concerns about some Eastern European economies have contributed to a weakening of

1.4.1 Recessions in developing Asia: Stylized facts

The global downturn has struck developing Asia hard. It has reverberated through the region along the avenues of tighter credit, investor risk aversion, and trade contraction, despite developing Asia's limited exposure to toxic assets. But crises are not new to the region. Many countries have experienced them in one form or another in the past couple of decades, whether a financial, currency, housing, or more general real economic crisis.

The last economic crisis to hit the region, in 2001, was the fallout from the bursting of the dot com bubble: regional GDP growth declined to 4.8% from 7.1% in 2000. A more severe episode was the Asian financial crisis of 1997–98, when growth in developing Asia slowed initially from 7.5% in 1996 to 6.0% in 1997, before plummeting to 1.6% in 1998.

Many analysts and policy makers believe that the current crisis has not reached bottom, and that the economic aftershocks rocking developing Asia will not fully attenuate for some time. The extent of eventual damage to regional growth remains highly uncertain.

A closer look at previous crises in the region from 1961 to 2007 provides some indication on how developing Asian economies may fare in the turmoil. Hong, Lee, and Tang (forthcoming), in their analysis of business cycles[1] in Asia, offer five stylized facts about past crises.

First, average recessions in developing Asian economies were more frequent, longer lasting, and more severe than those in the economies of the Organisation for Economic Co-operation and Development (OECD). Using a sample of 21 Asian economies,[2] data suggest that these economies were in recession 13.3% of the time. The average recession lasted 1.6 years, had a 6.7% peak-to-trough decline in GDP, and posted a cumulative loss of 12.4%. In contrast, OECD countries were in recession 8.5% of the time. The *average* recession lasted 1.3 years, had a 1.7% peak-to-trough decline in GDP, and posted a cumulative loss of 2.6%. The same pattern held for *severe* recessions (that is, those in the top quartile of the distribution).

Second, an analysis of financial downturns (defined as credit contractions and stock price declines) shows that such downturns have similar characteristics to recessions. In particular, during 1961–2007 credit contractions and stock price declines tended to be more common, longer, and more severe in developing Asia than in the OECD (Box table 1). Financial downturns were apt to be more frequent and severe than recessions, in both developing Asia and in the OECD, given the volatile nature of credit and stocks.

Third, real and financial downturns in developing Asia tended to happen contemporaneously. In particular, credit contractions and stock price declines were likely to occur around the time of a recession, and credit contractions generally preceded stock price declines. Given that real and financial crises commonly

1 Characteristics of recessions, credit contractions, and stock price declines, 1961–2007

Type of crisis/ Economic group		All episodes			Severe episodes (top quartile)		
	Frequency	Duration	Amplitude	Cumulative loss	Duration	Amplitude	Cumulative loss
Recessions	(%)	(years)	(%)	(%)	(years)	(%)	(%)
Developing Asia	13.3	1.6	6.7	12.4	2.3	17.8	35.0
OECD	8.5	1.3	1.7	2.6	2.1	4.8	8.8
Credit contractions	(%)	(quarters)	(%)	(%)	(quarters)	(%)	(%)
Developing Asia	26.1	4.8	18.5	73.8	7.5	43.8	195.7
OECD	17.4	4.4	7.3	27.6	7.0	19.3	79.1
Stock price declines	(%)	(quarters)	(%)	(%)	(quarters)	(%)	(%)
Developing Asia	47.7	6.4	47.7	277.4	12.1	118.4	853.8
OECD	43.0	6.6	38.5	207.7	11.9	89.5	613.4

OECD = Organisation for Economic Co-operation and Development.

Source: Tables III-1 and III-2 in K. Hong, J.-W. Lee, and H. C. Tang. Forthcoming. "Crises in Asia: Historical Perspectives and Implications." Economics Working Paper Series, Asian Development Bank, Manila.

1.4.1 Recessions in developing Asia: Stylized facts *(continued)*

develop simultaneously, the resulting impacts were, as expected, more intense when financial crises turned out to be severe. Box table 2 characterizes synchronized recessions and severe financial downturns in developing Asia relative to recessions and financial downturns only. Values for OECD countries are also presented for comparison.

2 Characteristics of synchronized recessions and financial downturns, 1961–2007

Type of crisis/ Economic group	Frequency (%)	Duration (years)	Amplitude (%)	Cumulative loss (%)
Recession and severe credit contraction				
Developing Asia	9.3	1.3	7.4	8.7
OECD	3.7	1.6	3.2	4.8
Recession and no severe credit contraction				
Developing Asia	7.3	1.4	4.4	5.3
OECD	8.1	1.3	1.7	2.4
Recession and severe stock price decline				
Developing Asia	6.2	1.2	5.0	5.8
OECD	4.9	1.3	1.5	2.3
Recession and no severe stock price decline				
Developing Asia	12.4	1.6	4.0	5.3
OECD	4.9	1.1	1.3	1.6

OECD = Organisation for Economic Co-operation and Development.

Note: A financial downturn is defined as severe if it falls in the top quartile of the distribution.

Source: Table III-4 in K. Hong, J.-W. Lee, and H. C. Tang. Forthcoming. "Crises in Asia: Historical Perspectives and Implications." Economics Working Paper Series, Asian Development Bank, Manila.

Fourth, a financial crisis in developing Asia not only increased the severity of a recession in developing Asia, it also raised the likelihood of one. With a credit contraction, there was a 15% chance that a recession would ensue; a severe credit contraction raised the probability of recession to 39%. Similarly, a stock price decline implied a 19% likelihood of recession; a severe stock price decline raised the odds to 52%.

Fifth, financial downturns in the United States (US) raised the probability of such downturns in developing Asia. There was a 40% chance of a credit contraction in the region if there had been a credit contraction in the US. Similarly, the probability of a stock price decline in developing Asia was 51% if there had been a stock price decline in the US. As expected, these figures climbed to 63% and 88%, respectively, for severe financial downturns in the US.

However, not all financial downturns in the US resulted in recessions in developing Asia. There was only a 19% and 13% chance of a recession in the region if there had been, respectively, a credit contraction or stock price decline in the US. More widely, a recession in OECD countries suggested a 14% probability that developing Asia would suffer the same fate, though a severe recession in OECD countries raised the odds to 24%.

The continued coupling of developing Asia with OECD economies is affirmed by recent economic data. Amid prevailing expectations that the current global downturn will be deep and long, particularly because of the coordinated nature of the financial and real crises, the probability is rising that the region will fall into recession.

If developing Asia does suffer a recession, previous crises suggest that for the average economy in developing Asia, it will be longer than for the average industrial economy. However, given the notable heterogeneity among developing Asia's economies, some will recover sooner than others, just as some are falling into recession earlier.

Still, the extraordinary nature of the global turmoil renders uncertain the ultimate duration and severity of the current regional downturn. Eventually, though, the performance of regional economies will depend on global conditions and on regional governments' policy responses to bolster growth.

Reference

Hong, K., J.-W. Lee, and H. C. Tang. Forthcoming. "Crises in Asia: Historical Perspectives and Implications." Economics Working Paper Series, Asian Development Bank, Manila.

1 For an annual series X, period t is defined as a trough if $X_t < X_{t+k}$ for k = -1 and 1, and a peak if $X_t > X_{t+k}$ for k = -1 and 1.

2 Bangladesh; Brunei Darussalam; Cambodia; China, People's Rep. of; Hong Kong, China; India; Indonesia; Kazakhstan; Korea, Rep. of; Kyrgyz Republic; Lao People's Dem. Rep.; Malaysia; Myanmar; Papua New Guinea; Pakistan; Philippines; Singapore; Sri Lanka; Thailand; Uzbekistan; and Viet Nam.

currencies in the Asian region (excluding Japan), despite the absence of substantial real or financial linkages between the two regions.

Policy lessons for developing Asia

In the short term, it is critical for Asian monetary authorities to do as much as possible to continue supporting their financial markets and systems. The measures already carried out include liquidity injections, widening the range of assets that can serve as collateral, and extension of lending maturities. Other confidence-building measures have included expansion of deposit guarantees and currency swap arrangements with the central banks of major industrial countries.

While Asia does not suffer from an actual credit crisis, it does suffer from fragile public confidence in the financial system, as a result of continued global financial turmoil. In this environment, adverse developments in one financial institution could immediately spread to, and infect, the entire financial system. Therefore, regional monetary authorities should continue giving the utmost priority to maintaining confidence and resist the temptation to bask in the region's relative immunity.

In the medium and long term, Asian governments should take care to avoid drawing the wrong policy lessons from the limited financial effects on their region of the subprime crisis so far. The structural improvement of its financial systems since the Asian crisis has sheltered the region from the current crisis. Yet it is equally true that Asia was fortunate in that its banks avoided exposure to subprime-related assets. The impact on the region's financial stability would have been far worse had its exposure been higher. The more relevant general lesson for Asia is that even financially advanced economies such as the US must, eventually, pay a heavy price for imprudent lending and unsound policies. This gives Asian countries all the more reason to build on and further reinforce the postcrisis structural reforms, including the strengthening of prudential regulation and supervision.

The last point brings up a fundamental issue facing the prudential regulation and supervision authorities in Asia today. If financial innovation can wreak such havoc on even deep, broad, and sophisticated financial markets, the implication for financially underdeveloped Asian countries might be that they promote financial innovation "at their own (very high) risk." In fact, this is the type of reasoning that is used to call for slowing down or even halting financial reform in the region. However, financial backwardness, which fortuitously protected Asia this time around, carries costly risks of its own, as was painfully highlighted by the Asian crisis.

In addition, Asian banks have already reaped substantial benefits from innovations of their own, such as their strategic shift toward household and real estate lending in the face of weakened demand for business loans. It was not financial innovation itself that brought about the global crisis. Rather, it was the failure of regulators to identify and manage the risks stemming from innovation. It may be more productive for Asian countries to apply more specific lessons learned from the crisis—such as what type of risks arise from financial innovation—to their financial reform process rather than to halt the process. Indeed, the global crisis

may even benefit financial reform in Asia by enabling the region to avoid the regulatory mistakes of the industrial countries.

Impact on developing Asia's real economy

The recession that hit the G3 economies in 2008 has been transmitted to developing Asia (Box 1.4.1) primarily through the trade channel and, as noted in the previous subsection, only secondarily through the financial channel.

Impact on trade

The plunge in G3 income has led to a reduction in G3 import demand that has resulted in a sharp contraction in developing Asia's exports. The situation reflects the positive correlation between G3 non-oil imports and Asian exports (Figure 1.4.5). The correlation has doubled from less than 0.5 in 1996–2000 to almost unity in 2001–2008. The correlation was stronger for the US and Japan than the eurozone, but the strength of the correlation in the latter has risen.

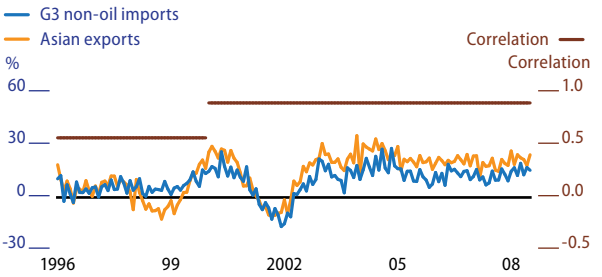
Since the fourth quarter of 2008, the drop in developing Asia's export growth has been huge—averaging nearly 30% in East and Southeast Asia and approaching double digits in South Asia. This dramatic reversal reflects the contraction in world trade volume in recent months, which appears to be caused by the evaporation of import demand in the industrial economies (Figure 1.4.6).

The financial turmoil and recession in the industrial world are both weighing on Asian exports. Trade finance through letters of credit has virtually ceased since the credit crunch took hold after the collapse of Lehman Brothers. The spread between US and UK Treasuries and the London interbank offered rate spiked in September 2008 (Figure 1.1.1 above) as banks began to hoard cash and refused making new loans. The Baltic Dry Index—an index of the cost of chartering bulk cargo ships—at one point had fallen by around 90% in response to the global liquidity crisis in late 2008, after testing record highs in the middle of the year. This reflected the sudden and sharp contraction in world trade as demand for bulk raw materials fell with industrial production and employment. The fall in incomes in the G3 also has had a strong impact in reducing demand for consumer electronics products, automobiles, and all other durable goods that figure prominently in Asian exports.

Intraregional trade

Although intra-Asian trade has been expanding more rapidly than Asia's trade with the rest of the world, particularly with the G3 markets, the nature of intra-Asian trade creates stronger links between the Asian and the G3 economies. As is pointed out in ADB (2007a) and ADB (2007b), because of rapid advances in production technology and technological innovations in transportation and communications,

1.4.5 Correlations between growth in developing Asian exports and G3 non-oil imports

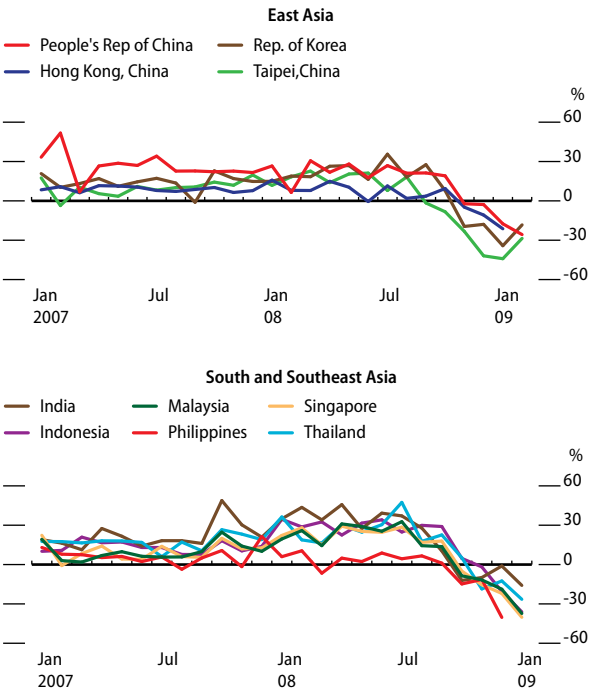


Note: Developing Asia excludes Bhutan; Taipei,China; and selected Pacific countries.

Sources: Staff calculations based on data from US Census Bureau, available: http://www.census.gov; CEIC Data Company Ltd.; Eurostat, available: http://epp.eurostat.ec.europa.eu/, all downloaded 16 March 2009; International Monetary Fund, *Direction of Trade Statistics*, CD-ROM, December 2008.

Click here for figure data

1.4.6 Export growth, selected Asian economies



Note: Export data for Hong Kong, China; Singapore; and Taipei,China include reexports.

Source: CEIC Data Company Ltd., downloaded 16 March 2009.

Click here for figure data

international product fragmentation—the cross-border dispersion of component production and assembly within vertically integrated production processes—and a shift in the composition of exports toward intermediate goods (parts and components) have become increasingly important over the past 15 years, particularly in East and Southeast Asia.

The growing importance of trade in these goods has been associated with the diversification of export destinations. The PRC has become one of the major export destinations for all economies in the region, particularly for machinery and transportation equipment exports, at the expense of the US and the EU. However, for the PRC, the US and EU markets have been increasingly important. This shows that the expansion of intraregional trade reflects the PRC's role as an assembly point for Asia and its greater reliance on demand from outside the region. Through its forward linkages to the PRC, the rest of the region also remains dependent on external sources of final demand so that Asia is still closely linked and highly harmonized with G3 markets.

Varying intensity by sector

The effects of the G3 demand slowdown vary across industries and countries. Electronics have been severely affected since the extent of intra-Asian trade in parts and components in this industry is perhaps larger than in any other industry. In addition, this industry is probably more dependent on the G3 markets than others and the products of this industry display high world income elasticity. As pointed out by Athukorala (2004, 2006), world income is more important for sectors with a high incidence of parts and components trade than in the case of other sectors. Therefore, the G3 slowdown is likely to have a relatively larger effect on the electronics industry and on economies where it is relatively important, e.g., Korea; Malaysia; Philippines; Singapore; and Taipei,China.

For example, US imports of computers and related equipment from developing Asia declined in both 2007 and 2008 but the rate of decline of annual imports was modest in 2008 at 3.4% for computers—Harmonized Tariff Schedule (HTS) 8471—and 10.0% for office equipment (HTS 8472). In contrast, in early 2009 there are indications that the contraction in US imports has become more severe with year-on-year contraction of 30% (year to date) in HTS 8471 and of 29% in HTS 8472. Another alarming aspect of the recent data is that developing Asia is losing market share as its decline in shipments of electronic products to the US market is faster than from the world as a whole.

Singapore is perhaps the most badly hit export-oriented economy in the region. Non-oil exports have contracted for 10 consecutive months but have plunged in the past 3 months (December by 21%, January by 35%, and February by 24%). Electronics exports (largely consisting of parts and components of computers and related equipment such as hard disk drives) fell by over 30% in the first 2 months of 2009, and non-electronic exports dropped by a little under 20% as well.

In general, labor-intensive industry exports may also be adversely hit. Although the income elasticity of demand for clothing, footwear, and toys is likely to be relatively lower than for electronics, since G3 markets are still important for developing Asia, countries that produce a large proportion of these products, such as Bangladesh, Cambodia,

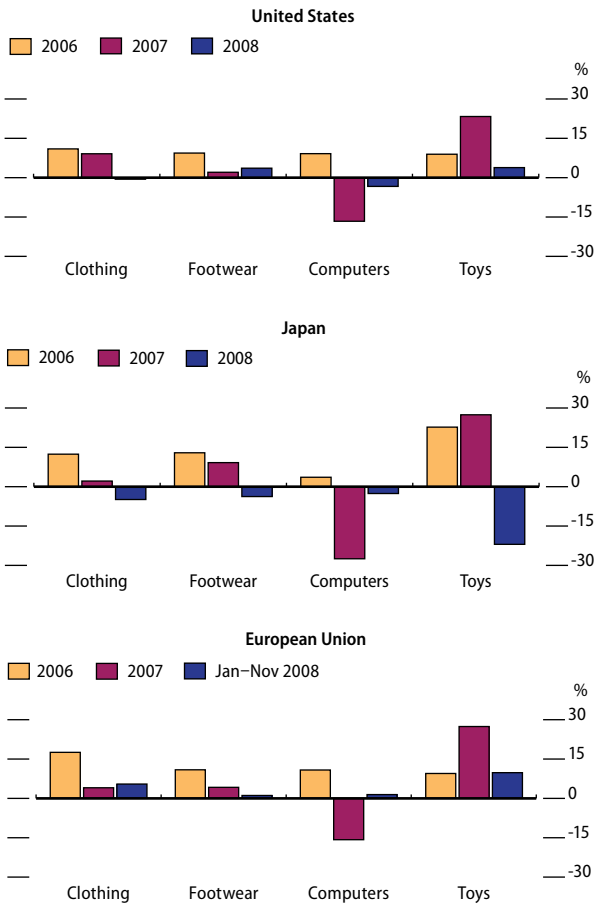
Indonesia, and Sri Lanka, could be significantly affected from the G3 recession. In contrast, the effect of the G3 slowdown is likely to be relatively small in countries where a much larger share of production is in more standardized industries like food products. In 2008, US imports of clothing and of computers fell absolutely while imports of footwear and toys grew at a sluggish pace (Figure 1.4.7).

Recent data for US imports of clothing indicate that demand is falling. Imports from all suppliers fell by 7% in January 2009 compared with the same month in 2008 in volume (and by 6% in value). The impact varied strongly across Asian suppliers with Hong Kong,China; Korea; and Taipei,China experiencing a wrenching decline of 45% in volume and over 50% in value in the first month of 2009; in contrast ASEAN suppliers experienced a 2% gain on both measures. The PRC and India provide contrasting results, with the PRC volume falling by 3% but with higher unit prices value improved by about 8%, while India suffered, despite a 10% volume increase, because prices plunged, leading to an 8% value decrease. Explaining the churning in market shares within Asia are underlying productivity and cost factors.

Japanese import statistics for 2008 are also indicative of the deterioration of demand for Asian goods. Imports of clothing, footwear, computers, and toys all declined in 2008. The declines reflect the onset of recession in the last 2 quarters of 2008 as real income growth turned negative.

In the EU a more nuanced picture emerged in the January–November 2008 import statistics in these product categories. Imports of all four product categories remained positive but minimal in the case of footwear and computers, and declined sharply in 2008 relative to 2007 in the case of toys. Clothing imports slowed in 2007 and rebounded in 2008 as safeguard quotas on important categories of PRC shipments were lifted from 1 January 2008. Footwear import growth fell largely because of the implementation of antidumping duties on shipments from the PRC and Viet Nam. The developments in clothing and footwear are indicative of the risk that protectionism could throttle international trade and with it, exports of developing Asia.

1.4.7 Growth of G3 imports from developing Asia



Note: Data for "computers" include computing equipment; while "toys" include games and sports equipment.

Sources: International Trade Administration, Office of Textiles and Apparels, available: http://otexa.ita.doc.gov; United States International Trade Commission (USITC), USITC Interactive Tariff and Trade DataWeb Version 3.0.0, available: http://dataweb.usitc.gov; Ministry of Finance, Trade Statistics of Japan, available: http://www.customs.go.jp/toukei/srch/indexe.htm; Eurostat, available: http://epp.eurostat.ec.europa.eu/, all downloaded 16 March 2009.

Click here for figure data

Impact on employment and investment

The contraction in Japanese imports from Asia coupled with worsening conditions in the US has caused factory closures and layoffs in labor-intensive industries in the PRC and Southeast Asia. There are also signs that EU imports from Asia are declining in early 2009 and this may exacerbate the production and employment impact on manufacturing in Asia.

The recent nominal and real exchange rate depreciation in some Asian countries may help to limit the negative impacts from the G3 demand slowdown. The recent strengthening of the US dollar and Japanese yen against other major currencies after the financial turmoil resulted in depreciation of the nominal effective exchange rates in many Asian countries. In the Philippines and Thailand, the nominal effective

exchange rate began to depreciate in early 2008, reversing a trend of appreciation since 2005, while for India, Indonesia, and Korea, nominal depreciation has been seen since 2007. In response to nominal depreciation, the real effective exchange rate in these three countries has depreciated since 2007.

Real depreciation was still limited in other countries as their domestic prices increased more than those of G3 countries and their nominal exchange rate depreciation. However, as noted by Athukorala (2004) and Jongwanich (2007), rapid diversification of exports away from traditional products and toward assembly/component specialization within global industries has tended to weaken the link between the real exchange rate and export performance. The exchange rate channel would become relatively less important in affecting export performance while world (income) demand has increased in importance in determining exports (see Part 2 for a detailed discussion of the real exchange rate effects on developing Asia's trade).

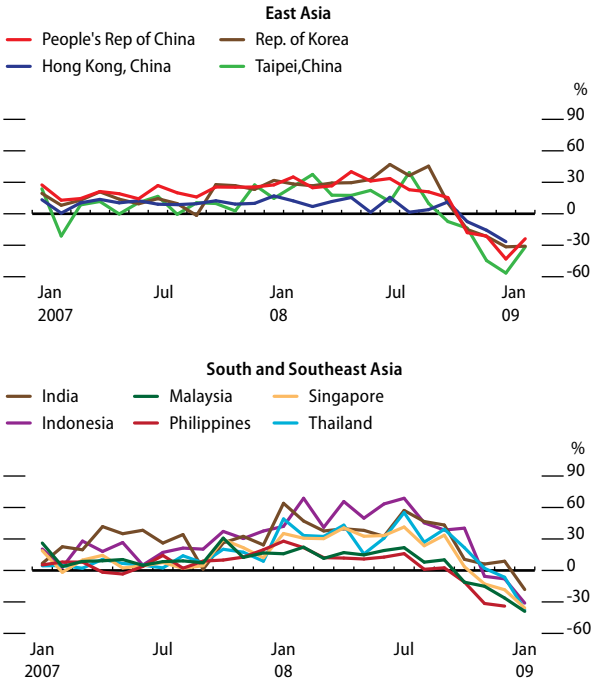
Imports in developing Asia have fallen off at about the same rate as exports (Figure 1.4.8). The decline in imports may also partially stem from the contraction in global demand for Asian final goods in the G3 markets—reflecting a collapse in trade in intermediate goods used in their production. However, there is also concern that the contraction in imports may also indicate a softening of domestic demand within developing Asia.

Numerous factory closures and layoffs have been reported across the region, particularly in electronics and in the most labor-intensive industries such as toys. These layoffs may be weighing on consumer sentiment in export-dependent newly industrialized economies such as Taipei,China, in Southeast Asia and in the PRC. If this is the case, indicators such as retail sales should also be declining. Thus the recession in the industrial world is weighing down growth in developing Asia in an increasingly severe manner.

The impacts of lower growth on unemployment have now become quite visible. Data through January 2009 display an upward movement in Hong Kong, China; Korea; and Taipei,China (Figure 1.4.9). Retail sales, reflecting private consumption expenditures, began to weaken in 2008 in many Asian countries. Data up to January 2009 show a clearer trend notably in Korea and Viet Nam. Though fluctuating, the downtrend is also discernible in the PRC and Hong Kong, China (Figure 1.4.10).

The decline in imports may also reflect reduced investment—particularly foreign direct investment as demand for capital goods imports contracts (Figure 1.4.11). Data on imports of capital goods and equipment in the most adversely affected group of developing Asian economies, the newly industrialized economies, indicate that investment demand is falling dramatically. Beginning in late 2008 and in early 2009 imports of capital goods contracted sharply and all but disappeared in the case of Taipei,China.

1.4.8 Import growth, selected Asian economies

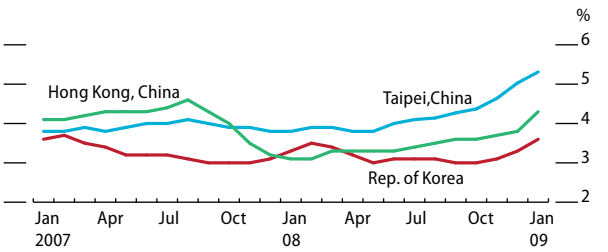


Note: Import data for Indonesia pertain to those outside the Ben Zone, or Bonded zone, an area within Indonesian Customs where special regulations regarding customs are in effect.

Source: CEIC Data Company Ltd., downloaded 16 March 2009.

Click here for figure data

1.4.9 Unemployment rates, East Asia



Source: CEIC Data Company Ltd., downloaded 16 March 2009.

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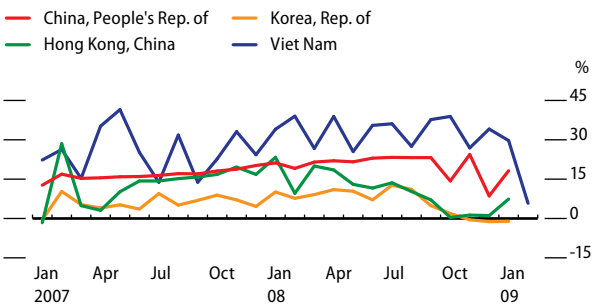
1.4.10 Annual change in value of retail sales, selected Asian economies



Source: CEIC Data Company Ltd., downloaded 16 March 2009.

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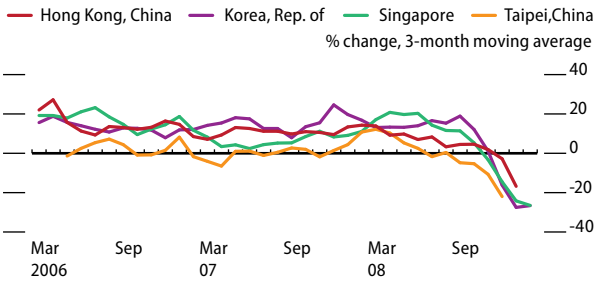
Impact on poverty reduction

Taken together, the real economy impacts of the financial turmoil and G3 synchronized recession are likely to be quite significant in developing Asia and will almost certainly lead to lower economic growth in the region. The extent to which real GDP growth is reduced in turn has important implications, not least for poverty reduction.

The implications of lower growth for poverty incidence depend essentially upon two variables—the level of expenditure per capita that is taken to draw the poverty line and the decline in growth in real per capita income that is caused by the global downturn. These issues are explored in countries for which household expenditure data are available in the following box (Box 1.4.2).

1.4.11 Imports of machinery and transport equipment



Source: CEIC Data Company Ltd., downloaded 16 March 2009.
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1.4.2 Poverty impact of the economic slowdown in developing Asia

How will the economic slowdown affect the incidence of poverty in developing Asia over the next 2 years? This box provides some numbers on the basis of various scenarios for economic growth and the empirical relationship observed between poverty and incomes between 1990 and 2005. Of course, the accuracy of the projected poverty estimates depends not only on how reasonable the growth scenarios for 2009 and 2010 are, but also whether the past relationship between economic growth and poverty reduction proves to be a good guide for the post-2005 period.[1]

Methodology

The empirical relationship between economic growth and poverty reduction observed between 1990 and 2005 is estimated on the basis of a simple linear regression model in which the log of the poverty rate (also known as the headcount index) is regressed on a constant and on GDP per capita.[2] The coefficient on GDP per capita is the estimate of the growth elasticity of poverty, that is, the percentage change in the poverty rate that is seen when GDP per capita increases by 1%. This relationship is estimated separately for two poverty lines: $1.25 a day and $2 a day, both at 2005 purchasing power parity (PPP). The former represents the international poverty line for extreme poverty while the latter is close to the median value of national poverty lines used in developing countries.

The regression is estimated separately for each Asian Development Bank subregion in order to account for the fact that the relationship between economic growth and poverty reduction is likely to vary within a region as large and diverse as developing Asia.[3] Assuming that each subregional growth elasticity applies to every country within a subregion, poverty in each country can be estimated on the basis of different scenarios for the growth of country-specific GDP per capita. In what follows, four different scenarios for economic growth are considered.

The baseline scenario is one in which each country's growth in GDP per capita for the years 2008, 2009, and 2010 is identical to that it experienced in 2007 (a year of rapid growth for many developing Asian economies). The baseline scenario is thus one where the economies in the region do not experience any slowdown relative to 2007.

The next three scenarios correspond to different degrees of economic slowdown. In particular, the scenarios consider what happens if growth in GDP per capita is 1, 2, or 3 percentage points slower in each of the 3 years 2008, 2009, and 2010 compared to growth in 2007. For example, if a country's GDP per capita grew by 7% in 2007, the baseline scenario is one where GDP per capita grows by 7% in each of the post-2007 years. In sharp contrast, the scenario of 3 percentage points slower growth is one where GDP per capita growth would be 4% in each of the post-2007 years.

Poverty estimates

The box table provides estimates of poverty in developing Asia for the various growth scenarios. These estimates are aggregates of those for each of the 24 developing Asian economies for which sufficient data were available on both poverty and economic growth. Together, these 24 economies account for 95% of the population of all developing Asian economies.

Rows 1 and 6 describe poverty in 2009 and 2010 under the baseline scenario for the $1.25-a-day and $2-a-day poverty lines. In the baseline scenario of no economic slowdown, there would be 586 million $1.25-a-day poor in developing Asia in 2010 and a little over 1.4 billion $2-a-day poor.

1.4.2 Poverty impact of the economic slowdown in developing Asia (*continued*)

Headcount index and number of poor in developing Asia in 2009 and 2010, four scenarios[a]

Scenario	Headcount index (%)		Number of poor (million)		Additional poor[b] (million)	
	2009	2010	2009	2010	2009	2010
$1.25 baseline	**19.1**	**16.7**	**665.9**	**585.9**	-	-
1 pp less growth	19.7	17.6	686.5	619.0	20.7	33.5
2 pp less growth	20.3	18.5	706.6	651.5	40.8	65.9
3 pp less growth	20.9	19.4	726.5	683.3	60.7	97.7
ADO 2009 projections	*20.9*	*19.5*	*728.2*	*682.9*	*62.3*	*99.9*
$2.00 baseline	**43.9**	**40.7**	**1,526.8**	**1,431.0**	-	-
1 pp less growth	44.6	41.9	1,552.6	1,472.5	25.8	41.9
2 pp less growth	45.4	43.0	1,577.7	1,513.2	50.9	82.6
3 pp less growth	46.1	44.2	1,602.6	1,553.1	75.8	122.5
ADO 2009 projections	*46.2*	*44.4*	*1,608.3*	*1,558.0*	*81.5*	*131.3*

pp = percentage point.

[a] Based on 24 developing Asian economies. [b] Relative to baseline scenario.

Source: Staff estimates.

Row 2 describes poverty in a scenario of a mild slowdown (GDP per capita growth in each year after 2007 is 1 percentage point lower than in 2007). If each country experiences growth in GDP per capita in 2008 and 2009 that is 2 percentage points slower than that in 2007 (row 3), there will be 41 million additional $1.25-a-day poor compared to the baseline scenario. If this slower growth rate were to continue in 2010 as well, there would be 66 million additional poor by 2010 (compared to the baseline scenario).

If growth is even slower, in particular, growth in 2008, 2009, and 2010 is 3 percentage points slower than that in 2007 (row 4), 61 million additional poor by 2009 and almost 98 million additional poor by 2010 compared to the baseline scenario could be expected.

If the poor are defined in terms of the $2-a-day poverty line, and growth in each year after 2007 is 3 percentage points lower than that in 2007 (row 9), 76 million additional poor by 2009 and 122 million additional poor by 2010 may be seen, compared to a situation where growth post-2007 was maintained at 2007 rates.

One cannot know now which is the most accurate scenario, but worryingly, projections of poverty based on growth rates of 3 percentage points slower than in 2007 for the post-2007 period are very similar to projections based on *ADO* country-specific estimates of economic growth for 2008 and forecasts for 2009 and 2010 (rows 5 and 10 for $1.25 and $2 poverty, respectively).

Based on these figures, it is clear that getting economic growth back on track and providing mechanisms for protecting the welfare of the poor and vulnerable until then are imperative.

1 To estimate poverty incidence at the country level, one requires a nationally representative survey of household expenditure. Unfortunately, for many countries 2005 is the most recent year for which such data are available. Thus, estimates of poverty incidence for any year from 2006 to 2008 must rely on extrapolations even though these years lie in the past. As for poverty incidence for any year after 2008, these must be forecasts of some type, of course.

2 That is, the regression equation is: $\ln P_{it} = \alpha + \beta^* ln Y_{it} + \varepsilon_{it}$, where i denotes country, t denotes year, and P and Y represent the poverty rate and GDP per capita, respectively. Data on poverty rates and GDP per capita are from World Bank's PovcalNet database and the *World Development Indicators*.

3 Details are given in R. Hasan, J. Cain, and M.R. Magsombol. Forthcoming. "Poverty Impact of the Economic Slowdown in Developing Asia: Some Scenarios." Economics Working Paper Series, Asian Development Bank, Manila.

4 The 24 developing Asian economies are Armenia, Azerbaijan, Bangladesh, Bhutan, Cambodia, People's Rep. of China, Georgia, India, Indonesia, Kazakhstan, Kyrgyz Republic, Lao People's Dem. Rep., Malaysia, Mongolia, Nepal, Pakistan, Papua New Guinea, Philippines, Sri Lanka, Tajikistan, Thailand, Dem. Rep. of Timor-Leste, Uzbekistan, and Viet Nam.

Developing Asia's responses to the global turmoil

Initial responses by developing Asia's governments were efforts to safeguard the stability of banking and financial systems, particularly in light of the turmoil and loss of confidence after the collapse of major investment banks in the US. These responses were outlined above in the subsection, *Impact on developing Asia's financial stability,* and included preventive measures against bank runs, such as increases in the maximum amounts covered by deposit insurance and blanket guarantees of the liabilities of deposit-taking institutions. Existing cooperation mechanisms in developing Asia, such as the Chiang Mai Initiative, were expanded and strengthened between PRC, Japan, and Korea.

These responses were largely successful in shoring up the public's confidence that savings were secure. Panic was kept to a minimum (such episodes were rare, as in the case of run on the Hong Kong, China–based Bank of East Asia). These initial responses were followed up by proactive efforts by the region's central banks to ensure adequate liquidity and to ease credit and monetary policy. Policy rates have been cut across the region (Figure 1.5.1).

Banks in the PRC have ramped up lending in recent months as fears of inflation have receded and commodity prices have cooled considerably. Some sources indicate that lending in the 3 months of December–February by PRC banks is as large as over the preceding 12 months. That would be a significant offset to the contraction in demand resulting from the drop in PRC exports.

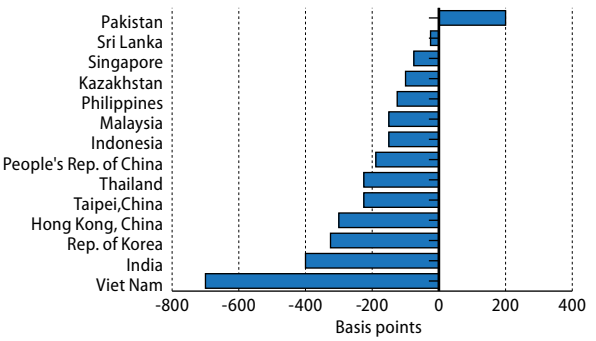
The governments in developing Asia have begun to implement fiscal stimulus packages as a way to offset the severe contraction in external demand for their exports and to rebalance growth toward domestic demand. Box 1.5.1 explores the nature and efficacy of fiscal stimulus programs in the region.

It is uncertain, however, that these conventional monetary policies and discretionary fiscal policies can continue to support demand until external demand recovers. Further, if the planned fiscal packages turn out to be ineffective or insufficient, many Asian economies will not have room to resort to additional fiscal packages. Prospects for GDP growth and contributing demand components in 2009 and 2010, are therefore, grim.

Given the weak projections for US import demand in the next 2 years, merchandise exports from developing Asia are expected to contract sharply in 2009, by 10.2% on average, before growing relatively slowly in 2010. Likewise, merchandise imports will suffer as the demand for inputs into export production will decline in tandem with the deteriorating exports.

Further, weakening construction, falling stock and property prices, and worsening labor market conditions all point toward deteriorating

1.5.1 Change in policy rates from 30 September 2008 to 16 March 2009



Sources: Bloomberg; CEIC Data Company Ltd., downloaded 17 March 2009.

Click here for figure data

1.5.1 Will Asian fiscal stimulus packages stimulate growth?

The severity of the global economic downturn since the fourth quarter of 2008 has prompted most governments in Asia to draw up fiscal stimulus measures in an attempt to stem the decline in domestic economies and to eventually drive growth higher. The possible impact of these measures on the gross domestic product (GDP) of these economies can be assessed through a macroeconomic simulation.

A CNY4 trillion ($586 billion) fiscal package was announced by the Government of the People's Republic of China (PRC), which included projects already planned before the economic slowdown. This package covers spending on infrastructure and housing, as well as for social development such as health care.

Tax cuts and additional spending, mostly for infrastructure, was included in a W33 trillion ($25 billion) fiscal stimulus package passed by the Parliament in the Republic of Korea. In addition, the 2009 Korean budget earmarks W24.7 trillion for infrastructure investment, up 27% from 2008. More than 60% of all budget spending is to be disbursed in the first half of 2009. Extra financial support for low-income families also was announced.

In India, the Government raised its expenditure by Rs800 billion in the fiscal year ended March 2009, with an emphasis on infrastructure investment and a reduction in the valued-added tax. A substantial increase in expenditure is planned for the fiscal year ending March 2010, together with cuts in excise duties and service taxes.

Malaysia rolled out two stimulus packages totaling RM67 billion ($18 billion) to support employment and families, to fund infrastructure, and to encourage private investment. Thailand is implementing a B117 billion ($3 billion) stimulus package that includes tax cuts and cash assistance to low-income households. It plans to invest B2 trillion ($56 billion) mainly in infrastructure over 4 years, but that is yet to be approved by the Parliament.

Elsewhere in Southeast Asia, the Philippines designed a P330 billion ($6.9 billion) fiscal package for spending on infrastructure and social programs to alleviate the impacts of its economic slowdown. Spending is intended to be fast-tracked in the first half of 2009. Similarly, Indonesia announced a Rp73.3 trillion ($6 billion) package focused on tax cuts, infrastructure projects that should generate employment, and assistance for those hurt most by declines in incomes. The 2009 budget for Singapore, which faces a deep economic contraction this year, included a "Resilience Package" amounting to S$20.5 billion ($13 billion). It is targeted at preserving jobs, buttressing bank lending, shoring up firms' cash flows, and supporting households.

Economies in both Hong Kong, China and Taipei,China are also forecast to contract in 2009. The former provided HK$24.1 billion ($3.1 billion) of fiscal stimulus in its 2009 budget, largely for tax concessions aimed at low-income households.

The latter allocated NT$605 billion ($17.5 billion) to be spent over 4 years and targeted at generating 200,000 extra jobs by 2012. Shopping vouchers valued at NT$3,600 (about $100) were handed out to all citizens early this year to promote consumption.

Measuring the effects of Asia's fiscal stimulus packages

To measure the impact of fiscal stimulus packages on selected developing Asian economies, Oxford Economics ran a simulation using its global macroeconomic model (Oxford Economics 2009) that treats government spending exogenously.[1] Assuming that the planned spending is in fact implemented, the model estimates changes in output levels relative to the baseline forecasts.

Assessing the effectiveness of the fiscal measures requires comparing the size of the packages (in relation to GDP) with the estimated impacts on output. The box table compares the estimated size of the multiplier (i.e., the

import demand for domestic inputs and consumption. Imports are therefore projected to fall, by 11.8% in 2009, or more than exports. The trade surplus of developing Asia will fall on average by 4.2% in 2009 before starting to grow again in 2010.

Investment demand is unlikely to recover before 2010. Past experience suggests that inventory adjustment, which has just begun, will take more than 4 quarters, and capacity utilization is still low. As fixed capital investment has been strongly correlated with export demand in the region, the uncertainty in the timing of US recovery is forcing investors to adopt a wait-and-see stance. Investment will not kick in until external demand starts to recover next year. Overall, the current account surplus in developing Asia is projected to shrink by 2.6% in 2009 to a still-significant $527 billion, of which the PRC accounts for about 80%.

1.5.1 Will Asian fiscal stimulus packages stimulate growth? (*continued*)

estimated extent of output increases) relative to the size of the fiscal package.

These results depend heavily on assumptions underlying the simulation. In the PRC, for instance, the simulation assumed that only about 30% of the announced fiscal package is likely to be new spending. Thus, GDP is expected to rise by just 1.3% in 2009 and 2.0% in 2010. However, if it is assumed that 50% of the package is fresh funds, the impact on output increases to 2.2% in 2009 and 3.4% in 2010. Furthermore, other government policies, such as steps taken to encourage bank lending not included in the simulation, will have an impact on GDP growth.

Impact of fiscal stimulus packages in developing Asia (simulation)

Economy	Package as share of 2009 GDP (%)	Impact on GDP (% change from baseline)		
		2009	2010	2011
China, People's Rep. of	1.2	1.3	2.0	1.5
Hong Kong, China	1.4	1.1	0.5	0.3
India	1.6	0.5	0.3	0.3
Indonesia	1.3	1.3	0.8	0.4
Korea, Rep. of	2.5	1.6	1.2	1.0
Malaysia	2.6	3.1	4.1	1.5
Philippines	4.1	2.4	3.5	1.7
Singapore	5.9	3.6	2.8	0.4
Taipei,China	2.1	1.4	1.2	0.7
Thailand	6.4	6.5	7.9	7.4

Source: Oxford Economics. 2009. "Emerging Asian Fiscal Policy: A Limited Boost, but China Could Yet Do More." *Emerging Markets Weekly,* 16 March.

The estimated impact on output in Thailand is much more significant than in the rest of the developing Asian economies, assuming the huge infrastructure spending that is under consideration is actually implemented. This spending has not been approved by Parliament and, if it is approved, spending will likely fall short of the target. Assuming that only half the package is actually disbursed, 2009 GDP would increase only by 3.7%.

In the Philippines, the planned stimulus package is projected to raise output by over 2% in the next 2 years. If spending falls short as a result of funding or other constraints and 50% of the announced package is implemented, the impacts on GDP would moderate to 1.4% and 1.9% in 2009 and 2010, respectively.

The ultimate impact on economies will depend on a variety of factors. The degree of openness to trade is a key determinant in fiscal policy effectiveness: in an economy as open as Singapore, for example, much of the fiscal stimulus will leak to other economies. A country's debt position is important if its fiscal stimulus requires much higher levels of government borrowing. A serious deterioration in fiscal and debt positions could prompt a downgrade in a country's credit rating, raising its cost of funds. Financing additional public spending could crowd out the private sector's access to funds. Moreover, while the intent to boost spending is clear, many governments face constraints that hamper implementation. These include constraints in funding and in institutions—public agencies in developing economies often lack the capacity to plan and implement large spending projects in a timely way. In designing fiscal policy responses to the global downturn, governments must take these considerations into account.

1 The model covers 44 advanced and emerging economies and six regional trading blocs. Among the emerging economies included in the model are 10 from developing Asia: People's Rep. of China; Hong Kong, China; India; Indonesia; Rep. of Korea; Malaysia; Philippines; Singapore; Taipei,China; and Thailand. The model, which is updated on a monthly basis, uses the most recent historical data of key macroeconomic variables as well as baseline forecasts for the next 5 years. The February 2009 model release was used for the simulation.

Emerging from crisis: A need to rebalance growth

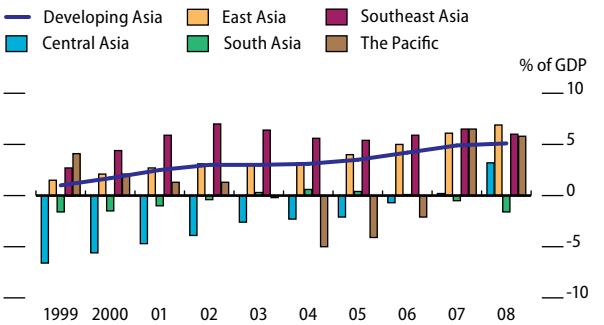
Developing Asia—especially East Asia and Southeast Asia—has traditionally relied on exports to achieve rapid economic growth and development, but current account surpluses have emerged only since the Asian financial crisis of 1997–98. The size of the surplus (relative to GDP) has increased markedly in recent years (Figure 1.6.1), and has coincided with, and partly accounts for, the large and growing deficit in the US. In 2008, developing Asia's current account surplus as a share of GDP fell for the first time in 5 years. Nevertheless, in each of the past 3 years the surplus has exceeded 5% of regional GDP—a large number in any historical or international context. Underlying the region's surplus is a large and growing imbalance between the region's output and expenditure or, equivalently, between its saving and investment.

Although developing Asia as a whole has been running a sizable and persistent surplus since the Asian crisis, the current account positions of the subregions vary widely (Figure 1.6.2). The subregional distribution of the current account surplus has been influenced by a number of cyclical factors such as changes in terms of trade and structural factors such as saving–investment imbalances. One important cyclical factor in recent years has been the runup in oil prices through July 2008, which largely explains the dramatic rise in the current account surplus in Central Asia (a large net exporter of oil), and the moderation of surpluses in East and Southeast Asia (both major net importers). In South Asia, another major net importer, the surge in oil prices helps explain the widening of the current account deficit in 2008. By the same token, the sharp decline of oil prices since July 2008 can be expected to have different impacts on the current account positions in the various subregions, with net importers benefiting—and vice versa.

A seemingly structural factor that has strongly influenced developing Asia's overall current account position is the persistent saving–investment imbalances that have emerged in East and Southeast Asia since the Asian crisis. In fact, those two subregions, in particular the PRC, account for well over four fifths of developing Asia's surplus. Part 2 of *Asian Development Outlook 2009* provides an in-depth analysis of the underlying causes of those imbalances as well as their consequences on the region's growth and welfare.

In particular, Part 2 delves into the issue of whether the unbalanced growth—excessive dependence on external demand—reflects too little consumption or too little investment in the region. The broader finding that follows from the analysis is that more balanced growth, and hence a

1.6.1 Five-year moving average of current account balance, developing Asia



Sources: International Monetary Fund, *World Economic Outlook* database (October 2008); *Asian Development Outlook* database; World Bank, *World Development Indicators* online database, downloaded 13 February 2009; staff estimates.

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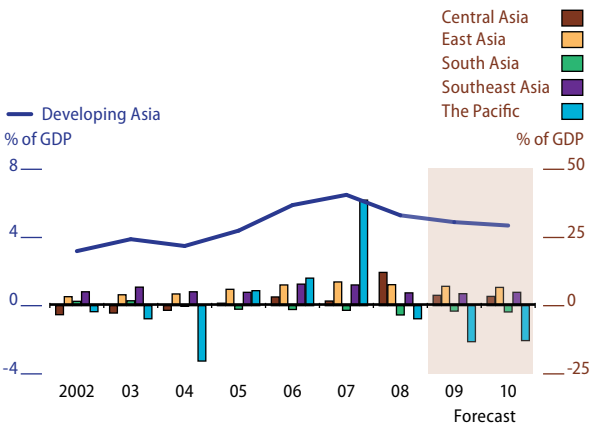
1.6.2 Current account balance, developing Asia



Sources: International Monetary Fund, *World Economic Outlook* database (October 2008); *Asian Development Outlook* database; World Bank, *World Development Indicators* online database, downloaded 13 February 2009; staff estimates.

Click here for figure data

reduction of the region's chronic surplus, is fundamentally in the region's own self-interest.

The current global financial crisis and economic downturn will likely reduce developing Asia's current account surplus somewhat. Projections indicate that the surplus will decline to 4.9% of GDP in 2009 and to 4.7% of GDP in 2010. Thus, despite some moderation of the surplus, it will still be large by any standards over the short term. Over a longer period, as the US deficit declines to more sustainable levels as part of that country's postcrisis adjustment, developing Asia's surplus will decline correspondingly.

However, the slow projected pace of surplus reduction over the next 2 years suggests that rebalancing the region's growth or, equivalently, the reduction of the region's excessive dependence on external demand, will not happen automatically. Instead, a wide range of government policies, ranging from boosting domestic consumption to promoting more competitive domestic markets, will be required to facilitate the transition of the region to a more balanced growth path.

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Part 2

Rebalancing Asia's growth

Rebalancing Asia's growth

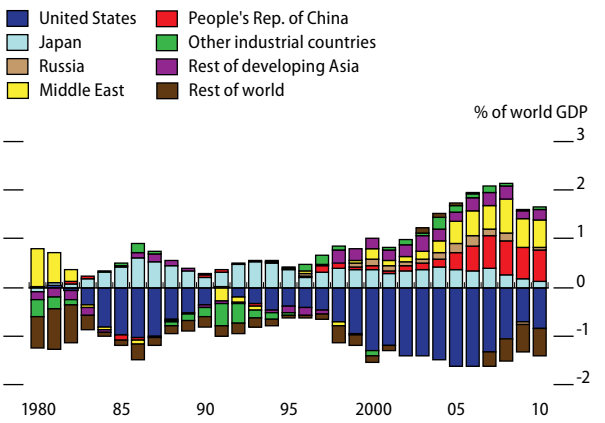
A question of balance

Two views about the origins of the global financial crisis predominate. According to one view, a combination of unsound macroeconomic policies—lax monetary policy and loss of fiscal discipline—and inadequate prudential regulation led to serious imbalances in the United States (US). This combination contributed to low saving rates, in the process widening current account deficits, and to a massive extension of credit to high-risk borrowers, especially in the mortgage market. The result was the bursting of an unsustainable housing boom with devastating effects on the balance sheets of financial institutions.

According to the other dominant view—the global "savings glut" hypothesis—excess saving in emerging markets generated low-interest financing allowing industrial countries to maintain high current account deficits. Lower global interest rates also encouraged a search for yield, including investments into risky housing-related assets such as subprime mortgages. These two views on the causes of the imbalances are not mutually exclusive and, in fact, they are complementary.

The global savings glut theory implicitly assumes that global current account imbalances (henceforth, global imbalances) played a major role in the outbreak of the global financial crisis. Global imbalances refer to the large current account deficits and surpluses that have emerged in the world economy since the Asian financial crisis of 1997–98 (Figure 2.1.1). For the most

2.1.1 World current account balance



Sources: International Monetary Fund, *World Economic Outlook* online database, October 2008; *Asian Development Outlook* database; staff estimates.

Click here for figure data

This chapter was written by William James, Shikha Jha, Juthathip Jongwanich, Donghyun Park, and Akiko Terada-Hagiwara of the Economics and Research Department, ADB, Manila. It draws on background papers that they prepared with Charles Adams, Peter Minor, Eswar Prasad, and Kwanho Shin, consultants.

part, the imbalances have been heavily concentrated in a small group of regions and countries, and until recently have displayed an unusually high degree of persistence. The imbalances have centered on the large current account deficits of the US, which peaked at close to 6% of gross domestic product (GDP) in 2006, and the corresponding surpluses in the rest of world, in particular developing Asia, the Middle East and the Russian Federation. By definition, a current account deficit (surplus) is equal to negative (positive) net saving (Box 2.1.1). The respective current account positions of the US and developing countries imply that developing countries (lenders) have become net capital exporters to the US (borrowers).

Such a flow of capital from developing to industrial countries implies that capital has, in effect, been flowing "uphill" from regions where the marginal returns to capital are high to regions where they are low. This raises serious doubts as to the optimality of these flows. The doubts are reinforced by the spending patterns in rich countries. For example, the low US saving rate shows that the flows of capital from developing Asia and elsewhere were essentially financing current consumption and purchases of housing by subprime borrowers. It is unclear how borrowing to finance consumption rather than investment would augment the borrowing country's productive capacity and hence its ability to repay

2.1.1 The relationship between saving, investment, and the current account balance

In the national accounts of an open economy,[1] national income (Y) is defined as the sum of private consumption expenditure (C), public and private investment expenditure (I), government consumption expenditure (G), and exports of goods and services (X) less the value of imports of goods and services (M):

$$Y = C + I + G + X - M \qquad (1)$$

The difference between the value of exports and the value of imports ($X - M$) denotes the current account balance (CA). When the value of a country's exports is greater than that of its imports, that country has a current account surplus. When the value of its imports is greater than that of its exports, that country has a current account deficit.

Substituting the current account definition into equation (1) and rearranging the terms gives:

$$Y - (C + G) = I + CA \qquad (2)$$

National saving (S) is defined as that part of national income that is not used for consumption, or $Y - (C + G)$ in equation (2). Substituting the definition of national saving into the equation gives a relationship between saving, investment, and the current account balance:

$$S = I + CA \qquad (3)$$

Alternatively,

$$S - I = CA \qquad (4)$$

This identity shows that net saving is equal to the current account balance. It implies that when a country saves more (less) than it invests, it incurs a current account surplus (deficit). A country can reduce its current account surplus by reducing its saving (that is, increasing private or public consumption) or raising its level of investment.

Alternatively, the accumulation of savings can be thought of as an accumulation of claims on domestic assets (in the form of investment) or foreign assets. Foreign assets can take the form of loans (for example, through direct lending or the purchase of debt instruments), investments, or the foreign reserve holdings of the central bank.

A current account surplus then must be balanced by the country by, on net, lending funds abroad, making investments in other countries, or by the central bank increasing its holdings of foreign reserves. This means that if a current account–surplus country is also a net receiver of foreign direct investment, balance would have to be achieved through even greater foreign lending by the country, or through more rapid acquisition of foreign reserves by its central bank.

1 For the sake of simplicity, this formulation ignores cross-border payments of wages, interest, and royalties (net factor income from abroad), as well as remittances from citizens living overseas (net current foreign transfers). Although these additional sources of disposable income are also part of the current account balance, including the additional terms does not change the underlying logic.

loans. This, then, raises doubts not only about the optimality of the current pattern of capital flows, but also whether the unwinding of these imbalances will undermine global macroeconomic stability.

Intuitively, borrowing from abroad to finance consumption would seem to be less sustainable than borrowing to finance investment. An economy running large current account deficits will likely see a rise in the ratio of its external debt to GDP. Some commentators raised the alarm due to the unprecedented magnitude of the US current account deficit and its growing net foreign indebtedness even before the financial crisis began (Roubini and Setser 2004; Bergsten and Williamson 2004). Although the US cannot expand its debt indefinitely, the level of debt at which new borrowing becomes unavailable is a point of debate. For example, Mussa (2004) states "There is probably a practical upper limit for US net external liabilities at something less than 100% GDP and accordingly … current account deficits of 5% or more of US GDP are not indefinitely sustainable." Other researchers (for example, Dooley et al. 2004; Cooper 2005; and Caballero et al. 2008) argue that the US can run very large deficits for an extended period in light of growing financial globalization, rising US productivity, and the financial underdevelopment of developing countries relative to the US.

Even if current account positions must eventually adjust, does that shift necessarily undermine macroeconomic stability? Obstfeld and Rogoff (2007) argue that exchange rate adjustments will eventually bring the current account back into balance. They estimate that the US dollar exchange rate could depreciate significantly—by 16–26% in real terms—in response to current account reversals. Edwards (2005) analyzes the international historical evidence to draw out the consequences of such an adjustment and finds that significant current account reversals tend to have pronounced negative effects on GDP growth. In a study of over 120 emerging markets during more than 25 years, Edwards (2002) finds that large current account deficits increase the probability of a financial crisis. In addition, Radelet and Sachs (2000) and Corsetti et al. (1998) find that large current account deficits were one of the principal factors behind the Asian crisis.

Few direct tests of the sustainability of US current account deficits are available in the literature. A study by Clarida et al. (2007) found, as of 2005, that the US was already beyond the threshold level that would trigger a current account adjustment and that it had been there for some time. Edwards (2005) develops a portfolio model of the current account to analyze the issue. The model predicts that, even under the highly optimistic assumption that foreigners' net demand for US assets doubles from its current level, the US current account will have to undergo a significant adjustment in the near future. An abrupt adjustment of the order of 3–6% of US GDP is conceivable.

The overall historical record suggests that the unwinding of the global imbalances will be disruptive. A more current example—the global financial crisis and the ensuing global economic downturn unfolding now—reflects this. Because the US economy is at the heart of the problem, and given the central importance of the US in the world economy as an export destination, the effects of the unwinding will be felt globally. The current crisis brings into stark relief the need to resolve the

global imbalances. To the extent that developing Asia's current account surpluses are an integral part of the story, it is necessary to lay bare the causes of those surpluses to deal effectively with global imbalances.

The region's surpluses ultimately come from the exceptional success of developing Asia's outward-looking export-oriented growth strategy. The rapid growth from this strategy has raised living standards and reduced poverty faster than any other region of the world over the last few decades (see, for example, Frankel et al. 1996; Fukuda and Toya 1995). While the region has long relied on exports to drive its growth, its transformation into a surplus region or, equivalently, a net exporter of capital is a more recent phenomenon. Only after recovery from the Asian crisis did the region's growth strategy begin to produce large current account surpluses. The distinction between developing Asia's export orientation and its current account surpluses matters because it is the latter that has contributed to global imbalances. Any discussion of rebalancing Asian growth must keep in mind that export-oriented growth is compatible with balanced growth.

It may be tempting for developing Asia's policy makers to believe that there is no need for adjustment—that the region can return to the precrisis dependence on exports as the primary growth engine. The temptation is all the stronger because this strategy has served the region so well in the past. However, several factors argue against this view. For one, given the sheer severity of the global crisis, much uncertainty surrounds the prospects for global recovery. For another, there are serious doubts as to whether running current account surpluses on a sustained basis serves the region's own self-interest. As mentioned above, economic theory suggests that poorer countries stand to benefit if capital flows to them from rich countries. Therefore, the logic of having a massive flood of capital flowing from developing Asia to the much richer US is questionable. More generally, developing Asia may have been paying a heavy price in terms of welfare and growth for its excessive dependence on external demand since the Asian crisis—that is, even before the outbreak of the current global turmoil.

The global crisis, as profound as its impact will be on developing Asia, did not create the need for rebalancing. Rather, it introduces an added urgency to rebalance growth. Increasing the importance of the region's domestic demand precludes a return to unsustainable current account surpluses (with the risk of future crises, as new imbalances are unwound). Moreover, a more balanced growth strategy can enhance social welfare. This part of *Asian Development Outlook 2009* (*ADO 2009*) argues that regional policy makers must make rebalancing growth a serious medium- and long-term objective, even as governments grapple with their short-term responses to the economic crisis.

Causes and consequences of global imbalances: Developing Asia's perspective

Profile of global imbalances

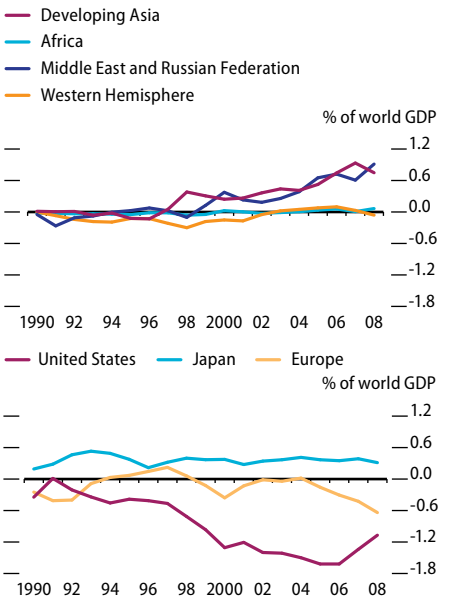
Current account imbalances in themselves are not a cause for concern. With increasing financial integration across countries, there is no reason why an economy's current account should balance every year. Nevertheless, the sheer size and persistence of recent imbalances—as well as their concentration in a small group of countries—are worrisome. Figure 2.2.1 shows the current account positions over time of key regions and countries as a share of world GDP.[1] The US current account deficit was flat during the 1990s, but widened sharply after 1997–98 as import growth surged. At its peak, it accounted for as much as 1.5% of world GDP before narrowing somewhat in 2007 and 2008. This is by far the largest current account deficit in the world in terms of absolute size.

The surge in the US current account deficit after 1997–98 was matched almost entirely by increases in the current account surpluses of developing Asia, the Middle East, and the Russian Federation. Current account imbalances thus became concentrated in a few countries following the Asian crisis. Asia has run current account surpluses consistently only after 1997. In fact, prior to the Asian crisis, current account deficits were the norm for developing Asia overall. Figure 2.2.2 depicts the current account positions of developing Asia, Japan, the Middle East and the Russian Federation in 2000, 2005, and 2007. It illustrates the fact that the surpluses from Asia, the Middle East, and the Russian Federation have consistently counterbalanced most US current account deficits, with the share of developing Asia in the aggregate surplus of these groupings increasing sharply since 2003.

Under balance-of-payments accounting, current account surpluses must be balanced by a buildup of claims on the rest of the world in the form of net private capital flows, non-reserve-related net official capital flows, and changes in international reserves. Figure 2.2.3 uses these variables to illustrate key features of the financing of global current account imbalances in recent years.[2] One similarity across all regions is a sharp increase in the accumulation of international reserves. However, the speed and scale of developing Asia's reserve accumulation has been exceptional.

The factors underlying such accumulation differ sharply across regions. In the case of developing Asia as a whole, it has been driven by both current account surpluses and net private capital inflows.[3] Developing Asia stands out for two reasons: exceptionally rapid rates of reserve accumulation; and large and growing surpluses in both the current and capital accounts—that is, twin surpluses.

2.2.1 World current account balances as share of world GDP



Note: Data for 2008 are estimates.

Developing Asia consists of Bangladesh; Bhutan, Cambodia; People's Rep.of China; Hong Kong, China; Fiji Islands; India; Indonesia; Kiribati; Rep. of Korea; Lao People's Dem. Rep.; Malaysia; Maldives; Myanmar; Nepal; Pakistan; Papua New Guinea; Philippines; Samoa; Singapore; Solomon Islands; Sri Lanka; Taipei,China; Thailand; Tonga; Vanuatu; and Viet Nam.

Middle East and Russian Federation consists of Armenia, Azerbaijan, Bahrain, Belarus, Egypt, Georgia, Islamic Republic of Iran, Jordan, Kazakhstan, Kyrgyz Republic, Kuwait, Lebanon, Libya, Moldova, Mongolia, Oman, Qatar, Russia, Saudi Arabia, Syrian Arab Republic, Tajikistan, Turkmenistan, Ukraine, United Arab Emirates, Uzbekistan, and Republic of Yemen.

Western Hemisphere consists of Antigua and Barbuda, Argentina, Bahamas, Barbados, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominica Dominican Republic, Ecuador, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaraguna, Panama, Paraguay, Peru, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago, Uruguay, and Venezuela.

Europe is composed of Emerging Europe and European Union.

Emerging Europe consists of Albania, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Former Yugoslav Republic of Macedonia, Poland, Romania, Slovak Republic, and Turkey.

European Union consists of Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Romania, and United Kingdom.

Source: International Monetary Fund, *World Economic Outlook* online database, October 2008.

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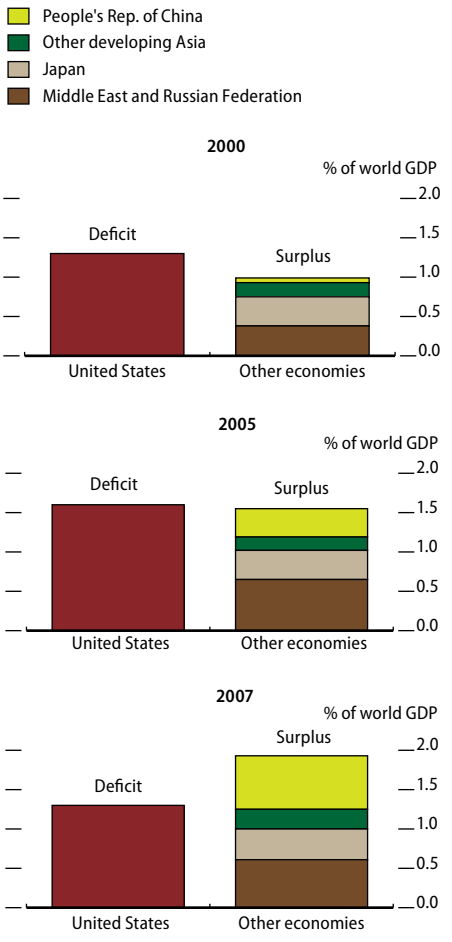
2.2.2 Current account deficits and surpluses, US and other economies



Notes: Current account data are in absolute values, showing deficits for the US and surpluses for other economies.

Other developing Asia consists of: Afghanistan; Bangladesh; Bhutan; Brunei Darussalam; Cambodia; Hong Kong, China; Fiji Islands; India; Indonesia; Kiribati; Korea, Rep. of; Lao People's Dem. Rep.; Malaysia; Maldives; Myanmar; Nepal; Pakistan; Papua New Guinea; Samoa; Singapore; Solomon Islands; Sri Lanka; Taipei,China; Thailand; Dem. Rep. of Timor-Leste; Tonga; Vanuatu; and Viet Nam.

For country composition of the Middle East and Russian Federation, see Figure 2.1.2.

Source: International Monetary Fund, *World Economic Outlook* online database, October 2008.

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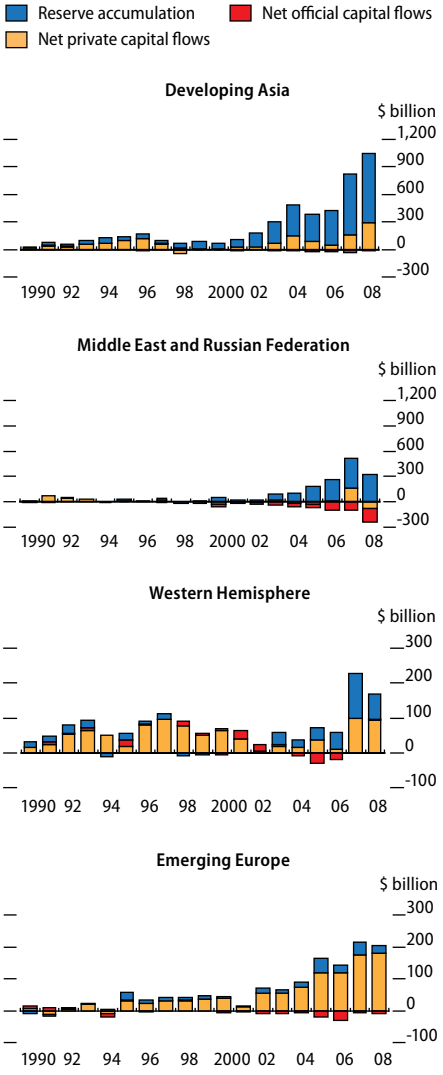
2.2.3 Current account financing patterns



Notes: Data for 2008 are estimates.

Developing Asia consists of: Bangladesh; Bhutan; Cambodia; People's Rep. of China; Fiji Islands; India; Indonesia; Kiribati; Lao People's Dem. Rep.; Malaysia; Maldives; Myanmar; Nepal; Pakistan; Papua New Guinea; Philippines; Samoa; Solomon Islands; Sri Lanka; Thailand; Tonga; Vanuatu; and Viet Nam.

For country composition of Emerging Europe, Middle East and Russian Federation, and Western Hemisphere, see Figure 2.1.2.

Source: International Monetary Fund, *World Economic Outlook* online database, October 2008.

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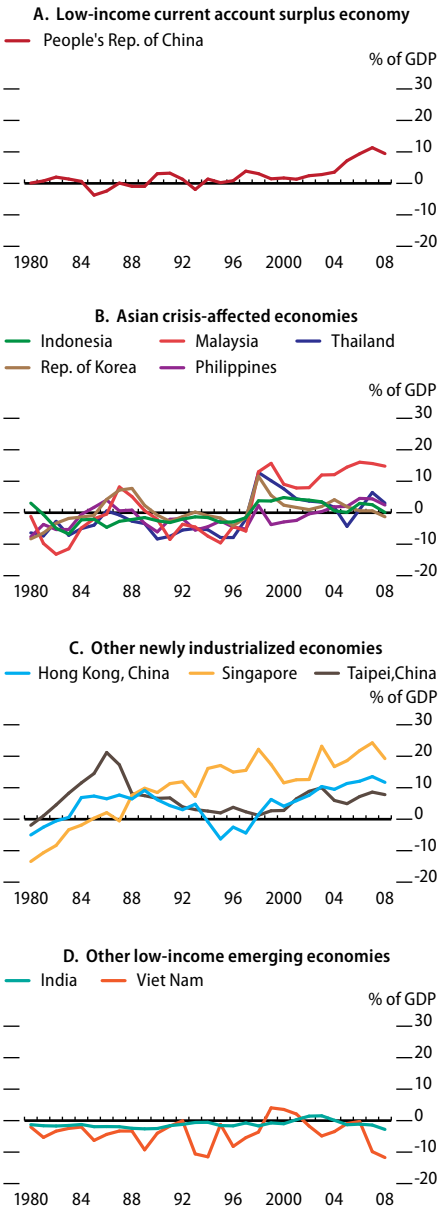
2.2.4 Asian current account imbalances



Note: 2008 data are estimates.

Source: International Monetary Fund, *World Economic Outlook* online database, October 2008.

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Viewing developing Asia's current account position overall obscures important cross-country differences. Figure 2.2.4 depicts the ratio of current account balances to own GDP for the eleven largest economies in the region for which data are available. These countries jointly account for more than 95% of regional GDP. The data reinforce the earlier observation that current account surpluses are a recent phenomenon rather than an intrinsic structural characteristic of developing Asia's economies. Adams and Park (2009) emphasize that, for most countries in the sample, the

surpluses only emerged following the Asian crisis. The only group of countries for which a current account surplus appears to be an intrinsic structural characteristic is that comprising Hong Kong, China; Singapore; and Taipei,China. The figure depicts four broad types of current account experiences.

- ***Low-income current account surplus economy*** (People's Republic of China [PRC]). In this case, the current account tended to be in small surplus, with the surplus increasing substantially in recent years.
- ***Asian crisis–affected economies***—Indonesia, Republic of Korea (hereafter Korea), Malaysia, Philippines, and Thailand. In these countries, current account positions shifted from deficits to large surpluses around the time of the Asian financial crisis, with surpluses narrowing in recent years, except in the case of Malaysia.[4]
- ***Other newly industrialized economies*** (NIEs)—Hong Kong, China; Singapore; Taipei,China. In these economies, current accounts have been in surplus for extended periods with the surpluses increasing in recent years.
- ***Other low-income emerging economies***—India, Viet Nam. In these countries, current accounts have on average remained in deficit.

Adams and Park (2009) point out that developing Asia's expanding current account surpluses since the late 1990s occurred in two distinct phases, with each phase being led by different groups of countries. In the immediate aftermath of the Asian crisis, the expansion largely reflected swings in the current account balances of the crisis-affected economies from positions of large deficit into large surplus. Since 2003, the increase largely resulted from a surge in the PRC's surplus. Surpluses in most of the crisis-affected economies have narrowed in recent years, while India's and Viet Nam's current account deficits have widened. To a significant degree, developing Asia's current account surplus has in recent years been closely linked to that of the PRC.

Causes of developing Asia's postcrisis current account surpluses

As mentioned above, persistent current account surpluses in developing Asia only emerged in the period following the Asian financial crisis; moreover, the composition of source-countries responsible for these surpluses has shifted over the decade since the crisis. What are the factors underlying these trends? In brief, a country's current account position mirrors its domestic saving–investment balance. Current account deficits occur when investment exceeds saving, with the excess of investment over saving being financed by foreign borrowing. Conversely, current account surpluses result when saving exceeds investment, the excess of saving over investment being lent abroad. From this perspective, one can view large and persistent current account surpluses as a symptom of "too much" saving or "too little" investment. One set of explanations for developing Asia's transformation into a chronic surplus region thus focuses on the causes of high saving rates, while the other focuses on the causes of

declines in investment rates, especially in the crisis-affected countries. A third approach, known as Bretton Woods II, considers the impact of exchange rate arrangements on the current account balance.

Too much saving?

Various explanations have been offered for the region's high and rising national saving rates. Since increases in the PRC's saving rate have exceeded those elsewhere in the region, much empirical work has focused on the PRC experience (Weimer 2008; Kuijs 2005), and in particular, on modeling the factors underlying the recent surge in the PRC's saving rate. At the same time, there has also been some empirical analysis of saving in developing Asia that seeks to understand the factors underlying global current account imbalances (IMF 2006a).

Figure 2.2.5 shows trends in the saving rate for the four groups of countries referred to above. The figure shows a noticeable spike in the PRC's saving rate since 2002. Saving rates for the three NIEs (Hong Kong, China; Singapore; and Taipei,China) have also increased since then, albeit much less sharply. While saving rates in the five crisis-affected economies (Indonesia, Korea, Malaysia, Philippines, and Thailand) were roughly similar during the pre- and postcrisis periods, saving rates in the deficit countries (India and Viet Nam) show a secular increase since 1990.

Several factors have been cited as possible contributors to the recent surge in regional private saving rates. These include rapid GDP growth, with a key finding from numerous saving studies being that rapid growth led to surges in saving rates; increased uncertainty in the wake of the Asian crisis, which led to an increase in precautionary saving; the region's ongoing demographic transition, in which the average age of its population increases; and financial development, which may have either a positive or a negative impact on saving.[5]

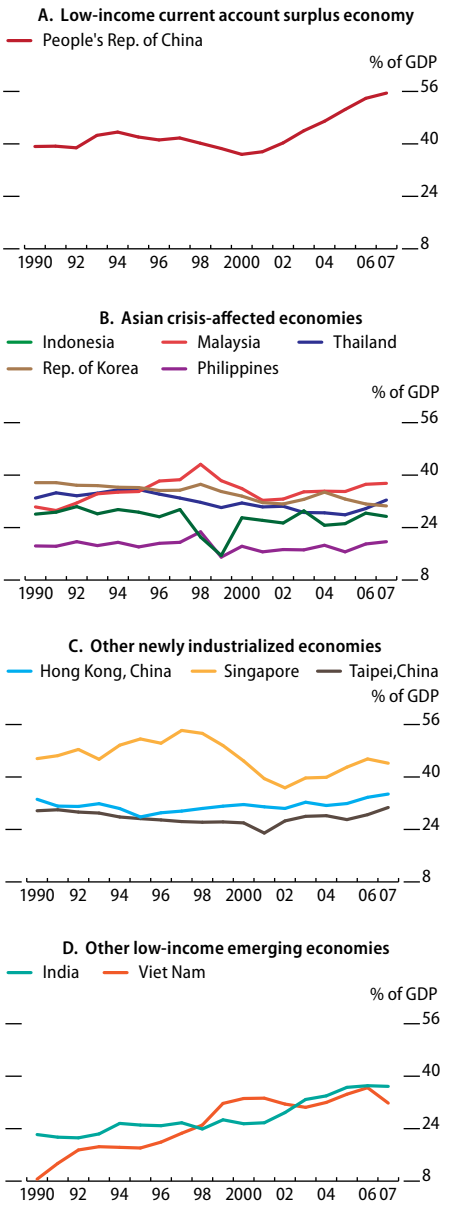
As typified by the International Monetary Fund (IMF) (2005) and Park and Shin (2009), two central findings across much of the empirical work are the region's rapid GDP growth in explaining its high private saving rate, and the role of demographic factors in various countries. Empirical studies indicate that saving rates in the region were somewhat higher than implied by standard relationships between saving and its fundamental determinants in the period immediately following the Asian crisis, perhaps as a result of a sharp rise in uncertainty; however, this effect appears to have waned in recent years (IMF 2006a; Bernanke 2005).

A robust finding in the research cited is that rapid economic growth accounts for much, but not all, of the recent surge in the region's saving rate, especially in the PRC. Given the PRC's exceptionally rapid growth in recent years, this effect probably explains a large part of the recent increase in the saving rate in that country. Elsewhere in the region, rapid GDP growth is at best a partial explanation for any increase in saving rates, given that average GDP growth during the past several years has tended to remain below its precrisis level (ADB 2007).

Too little investment?

Another explanation sees weak investment as accounting for the bulk of the region's postcrisis shift toward current account surpluses. There is some empirical support for this view in that with the notable exceptions

2.2.5 Saving rates of individual Asian economies



Sources: Asian Development Bank, *Statistical Database System*; CEIC Data Company Ltd., both downloaded 10 January 2009.

Click here for figure data

of the PRC, India, and Viet Nam, investment as a share of GDP across the region has been unusually low since the Asian crisis. In countries in which there had been massive overinvestment in real estate during the leadup to the crisis, the real estate sector tends to account for a significant share of overall investment weakness; this is understandable since a return to lower, more sustainable investment rates would be expected. For the most part, however, investment weakness has occurred across all components of investment, both in countries that were at the center of the crisis and those that were not.

Figure 2.2.6, which shows investment rates for all four groups of countries, confirms the decline in investment rates in the five crisis-affected countries. However, investment has recovered to a greater degree in Korea and Indonesia than it has in the other three crisis-affected countries. In the case of the PRC, the investment rate fell until the early part of this decade, but then increased sharply. The three NIEs show a pattern of long-term decline, as might be expected of mature, high-income economies. Conversely, the two low-income, high-growth current account-deficit economies show a pattern of secular increase in investment, as also might be expected.

There are four major explanations for the broad-based weakness of investment in the region that has occurred since the Asian crisis. The first sees investment weakness as a lingering effect of the crisis (Chinn and Ito 2005; Eichengreen 2006). This view sees postcrisis restructuring and reform—along with the working-out of precrisis investment excesses—as being important factors in explaining investment weakness in the crisis-affected economies during the postcrisis period.

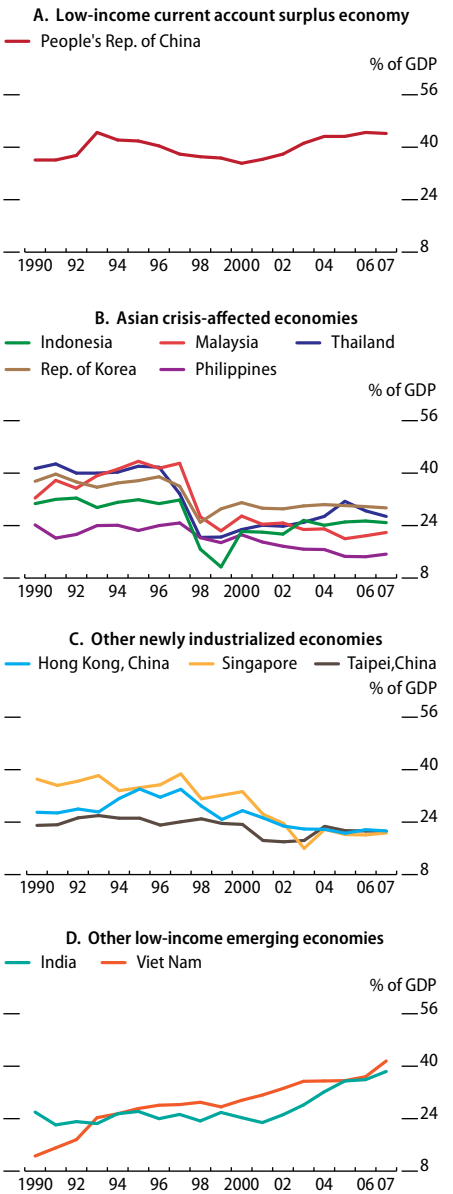
The second explanation (IMF 2006b; Wong and Adams 2002), argues that sharp increases in investment in the PRC were offset by cutbacks elsewhere in Asia. The third, which emphasizes the role of heightened regional risk during the postcrisis period (ADB 2007), views the Asian crisis as a "wake-up call" signaling a heightened level of risk in the investment environment. The fourth sees postcrisis investment weakness as reflecting shortcomings in the region's investment climate during that period (IMF 2006b).

Overall, postcrisis investment weakness across much of the region is a puzzle for which there is no clear explanation. Arguably, the Asian crisis played an important role in depressing investment in the period immediately following the crisis, but its effects have likely waned over time. Neither competition from the PRC, heightened risk, nor a deteriorating investment climate has had a clear effect on the level of investment in the region. In any event, weak investment is no longer the key factor in the region's large overall current account surplus. Since 2003, high and rising national saving rates have become the key contributor to the imbalance, especially in the case of the PRC, but also in the case of Hong Kong, China; Singapore; and Taipei,China.

Exchange rate arrangements?

The central assumption of the Bretton Woods II view is that much of developing Asia has implicitly returned to tightly managed US dollar exchange rate regimes after briefly flirting with floating exchange rates during the Asian crisis period.[6] Under these tightly managed regimes, the

2.2.6 Investment rates of individual Asian economies



Sources: Asian Development Bank, *Statistical Database System*; CEIC Data Company Ltd., both downloaded 10 January 2009.

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government is seen as systematically purchasing US dollars in the foreign exchange market to produce dollar strength, which thereby reduces the foreign exchange value of the home country's currency. This maintains export competitiveness, which allows rapid economic growth to be achieved in the home country.

Export competitiveness in turn allows current account surpluses to accumulate, which are then in part used to provide the external financing required by the US to cover its current account deficit. Finally, by financing the US current account deficit, the region's export-oriented countries support sustained purchases of Asian exports by US consumers.

The crux of this view is that the arrangement described above benefits both developing Asia and the US: the former by securing markets for its exports, which allows it to achieve rapid rates of economic growth; the latter by obtaining cheap external financing for its current account deficit via purchases of low-yielding US dollar reserve assets by Asian developing countries.[7]

In the Bretton Woods II view, exchange rate competitiveness (coupled with the monetary regimes that support them) explains how the region has simultaneously experienced rapid export and GDP growth, large current account surpluses, and rapid rates of reserve accumulation. While this view provides a comprehensive explanation of developing Asia's experience over the past decade, it suffers from serious shortcomings. In particular, its characterization of postcrisis exchange rates as dollar pegs (or quasi-pegs) is inconsistent with the flexible exchange rate regimes of Indonesia, Korea, and Thailand.

Summary

No single explanation can fully account for the current account imbalances generated by all countries in developing Asia over the past decade. The relative contribution of the various factors discussed above has likely varied across the subperiods that together make up the period since the Asian financial crisis. For example, the broad-based weakness in investment that occurred in the aftermath of the Asian crisis is understandable, but the decade-long persistence of investment weakness remains a puzzle. The recent surge in regional saving rates appears to stem mainly from rapid regional growth, but this explanation of investment weakness fails to address the causes of the high growth rates themselves. In short, both the postcrisis investment slowdown and the region's high and rising saving rates remain largely unexplained.

Consequences of global imbalances for developing Asia

As global imbalances unwind, the current financial turmoil is negatively impacting developing Asia's growth and hindering its poverty reduction efforts. Less obvious are the consequences of Asia's current account surpluses before the global economic slowdown began. Global imbalances impose two types of costs on Asia. First, the possibility that Asia's current account surplus may be suboptimal suggests that there may be costs associated with this suboptimality. Second, an excess of foreign exchange

reserves imposes costs on the country accumulating the reserves. Finally, since economic growth remains by far the top priority in developing Asia, what matters most is the possible negative consequences of global imbalances for the region's overall rate of economic growth.

Limits of developing Asia's export-led growth

Before delving into the issues of excessive current account surplus and foreign exchange reserves, it is useful to review the root cause of Asia's large and persistent current account surplus,—namely the highly successful export-oriented industrialization strategy it has pursued since World War II. While many factors allowed Asia to outperform other developing-world groupings during this long period, the most important of these was Asia's ability to produce and sell manufactured goods abroad.

The key question facing Asia is thus whether this strategy will continue to deliver strong economic growth. The global imbalances underlying the global financial crisis highlight the unsustainable nature of running large current account deficits over the long term. For Asia, the global financial crisis brought to the fore the limits of a growth strategy that ultimately rests on an ever-growing appetite for Asian exports.

Because developing Asia remains poor, by far the single most important determinant of the region's economic welfare remains GDP growth. The region cannot reduce poverty and inequality without adequate GDP growth, and so any discussion of the impact of global imbalances on the region has to touch on their implications for growth.

What should be of utmost concern to developing Asia's policy makers is the structural component of the ongoing deceleration in the region's exports. Achieving rapid growth by producing ever-larger quantities of an ever-wider range of manufactured goods is feasible as long as there are markets that can absorb those goods. However, the unfolding global crisis highlights the ultimately unsustainable nature of overproduction in developing Asia that is sustained by overconsumption in the US.

There is a widespread tendency in the region to point to rapid economic growth as the primary justification for relying on exports as an engine of growth. However, the global financial crisis rudely shatters the delusion that there are no limits to external demand and hence to export-led growth. Asia is no longer a small economy that faces an effectively infinite global market and can always export its way to high growth rates. There are also limits to which competitive exchange rates, emphasized in the Bretton Woods II view, can artificially promote exports in the long run.

Costs of oversaving and underinvestment

Asia's large and persistent current account surpluses can be viewed as a symptom of a high degree of dependence on external demand as the engine of growth. An equally valid interpretation of those surpluses is an excess of saving over investment. There are two potential types of welfare costs arising from the imbalance between saving and investment in Asia in the postcrisis period. One is oversaving—that is, whether the saving rate is beyond what would be predicted given economic

fundamentals—and the other is underinvestment. Along with its export-oriented industrialization strategy, high saving and investment rates have long been viewed as being integral to the East Asian growth model.

Although high saving rates have served Asia well in the past, the key question highlighted by the Asian crisis is whether the region now suffers from saving too much. This question is especially relevant for the PRC, given the country's high saving rate relative to its level of income. The welfare costs of oversaving are likely to be especially high in a poor country with low consumption levels and living standards. If the cost of oversaving is potentially large for developing Asia, so is the cost of underinvestment. The main tangible costs of a slower-than-optimal rate of capital accumulation are a reduction in future productive capacity and future rates of economic growth. A lowering of growth rates to suboptimal levels due to underinvestment is a huge cost indeed in light of the fact that developing Asia is still a poor region.

Costs of excessive foreign exchange reserves

One major consequence of persistent current account surpluses has been explosive growth of foreign exchange reserves held by the region's central banks. There is a growing consensus that the accelerated growth in the reserves of Asian developing countries may have led to excess reserves—that is, reserves in excess of optimal levels. The optimal level of reserves is determined by their marginal benefits and costs. Excess reserves are welfare-reducing by definition. According to Park (2007), both informal and formal analysis confirms the popular belief that developing Asia's reserves now exceed what is required for liquidity purposes by a wide margin, which implies correspondingly large welfare losses.

One specific cost of excess reserves is the return forgone by holding them in the form of traditional reserve assets—that is, safe and liquid but low-yielding assets such as US government bonds—rather than higher-yielding assets.[8] Parking excess reserves in liquid foreign currency assets that offer little additional protection against currency crisis has significant opportunity costs. Park (2008) estimates the benefits of managing excess reserves more actively and finds them to be higher than 1% of GDP in many Asian countries.

Costs of the global financial crisis for developing Asia

As should be clear by now, developing Asia will not be immune to the adverse effects of global imbalances. Most immediately, it is possible to interpret the current slowdown of economic activity in the region as a cost of global imbalances. A recent study (James et al. 2008) finds that the global financial crisis seems to have had only a limited impact on the region's financial systems thus far.

Yet, the real economies of the region are already bearing the full brunt of the global economic downturn precipitated by the crisis. The synchronized slowdown of economic activity under way in the G3 will have a pronounced impact on world trade and hence Asian exports and growth. GDP growth began to soften across the region in 2008, and ADB and most other forecasters expect an even sharper slowdown in 2009. In a region as poor as Asia, a 2–3 percentage point decline will tangibly constrain the resources and capacity to reduce poverty and income

inequality. Beyond the short term, to the extent that the US downsizes its current account deficit over an extended period, developing Asia will face a more permanent negative shock to its exports and growth.

Summary

Insofar as the current global financial and economic crisis reflects an unwinding of global imbalances, developing Asia is already paying a heavy price for those imbalances. In the short run, the collapse in G3 demand for the region's exports will severely dent the region's exports and growth prospects. In the medium and long run, the global crisis highlights the risks of excessive dependence on foreign demand. Unbalanced growth based on overdependence on exports may deliver faster growth in the short term, but can contribute to the buildup of unsustainable global imbalances over a longer time frame.

Given the excellent track record of export-led growth in the region, a regional mindset that favors exports over domestic demand is understandable. However, the global financial crisis has rudely awakened the region to the realization that the world's demand for the region's output is neither automatic nor guaranteed. Some specific welfare costs arising from the global crisis include those associated with suboptimal levels of saving, investment, and foreign exchange reserves.

Concluding observations

Global current account imbalances underlie the ongoing global financial and economic crisis. Global imbalances are as much a matter of unsustainable current account deficits as unsustainable current account surpluses. Further, other parts of the developing world—including most oil exporters such as the Middle East and the Russian Federation—have also contributed substantially to the surpluses. Nevertheless, the large and persistent surpluses that have emerged in developing Asia since the Asian crisis are an integral part of global imbalances.

Global imbalances will also have serious adverse consequences for Asia's growth prospects in so far as the global crisis—which is crippling the region's exports—partly reflects a disorderly resolution of those imbalances. One does not have to be an adherent of the global savings glut hypothesis to discern a connection between global imbalances and the global financial crisis. At a purely intuitive level, large and persistent current account deficits financed by large and persistent current account surpluses cannot go on indefinitely and will have to unwind at some point.

It is important to distinguish between the short-term and the medium- and long-term policy implications of the global crisis, which partly represents a disruptive resolution of global imbalances. In the short term, the undisputed priority of regional policy makers must be to manage the sharp slowdown in economic growth associated with the contraction of external demand. Such short-term management will involve both limiting the reduction of growth through expansionary fiscal and monetary policy as well as easing the hardship of those hardest hit.

At the same time, it would be prudent for regional policy makers to fully recognize the medium- and long-term ramifications of the

unwinding of global imbalances. Viewing the current slowdown as just another downturn of just another business cycle would be a serious mistake. The sheer size of the global imbalances suggests that their unwinding may require a protracted period of adjustment in the US. At a broader level, the global crisis highlights the inherently unsustainable nature of growth based on excessive dependence on foreign demand in the medium and long term. As such, it should serve as a wake-up call for policy makers to take concrete actions to rebalance their economies on a sustained basis.

However, *rebalancing does not imply turning back from the economic openness and integration into the world economy* that has delivered enormous benefits for developing Asia in the past and will continue to do so in the future. In particular, erecting trade barriers to protect domestic firms and workers may be politically tempting under the present circumstances, but will harm all countries in the region. What is hurting the region is not its traditional openness to international trade and capital flows, but unsustainable imbalance in the global structure of supply and demand. Large and persistent current account surpluses are not an intrinsic structural feature of developing Asia; in fact, the region as a whole ran deficits until the Asian crisis. Rebalancing represents a return to the generally more balanced structure of demand and growth that prevailed in the region prior to that crisis.[9]

Since the Asian crisis, developing Asia as a whole has been transformed into a region of chronic current account surpluses, or, equivalently, a chronic net exporter of capital. However, the behavior of the region as a whole and the existence of some common elements do not detract from the fact that the region's countries show a great deal of heterogeneity in terms of the size and nature of their surpluses.

Unusually high saving rates that reflect unusually low consumption rates explain the imbalance between output and expenditure in the PRC. In the crisis-affected countries, a sharp drop-off in investment rates against a backdrop of high and relatively stable saving rates explains the imbalance. Asian countries also vary widely in terms of their current account positions. For example, the ratio of current account surplus to GDP exceeds 10% in Malaysia and Singapore, but Korea's account is broadly balanced while India and Viet Nam are in fact running deficits. The lack of a one-size-fits-all explanation for the region's current account surplus precludes one-size-fits-all policy prescriptions.

Notwithstanding such heterogeneity, some rebalancing of growth toward domestic demand will be required for the region as a whole. In the absence of this rebalancing, the global economic crisis will have a pronounced impact on growth in highly export-dependent developing Asia. While necessary, rebalancing is bound to be a difficult, protracted, and complex structural process. Above all, the mismatch between the structure of output and the structure of demand in many export-oriented Asian economies will constrain the rebalancing of demand and growth.

The imbalance between what the region produces and what it consumes will not be resolved quickly as there are many structural reasons for the imbalances including the lack of social insurance, underdevelopment and incomplete financial (credit) markets, and limited competition among service products. However, a key regional

development that bodes well for rebalancing is the emergence of a large and rapidly growing urban middle class. The demand of this subpopulation for goods such as automobiles and household appliances is taking off, and laying the foundations for strong and sustainable domestic demand.

The intrinsically difficult and time-consuming nature of rebalancing developing Asia's economies entails a number of significant policy implications. For one, even under the most optimistic scenarios, it will be a daunting challenge for the region to achieve its exceptionally high growth rates in view of the drastically worsened global economic outlook. A more realistic and feasible goal may be to achieve growth rates that are somewhat slower than those of the pre–global crisis period, but are nevertheless still high relative to other parts of the world and, more importantly, high enough to make a dent in the poverty that still afflicts wide swathes of the region. It is up to regional policy makers to effectively communicate the reality of lower short- to medium-term growth prospects to the public, as well as to assist the hardest hit segments of the population to prevent social and political instability.

The fact that private domestic demand cannot be mechanically ramped up in a short period of time implies that the government must take the lead in rebalancing demand in the short run. In fact, governments around the region are already trying to pump up demand through activist fiscal policy in response to the collapse of external demand. However, the region's governments should also consider using fiscal policy for rebalancing purposes beyond the short term. In addition to becoming a "spender of last resort." Using fiscal policy to stimulate domestic demand involves creating the appropriate enabling environment for the private sector. For example, investing in the education system will help to alleviate the shortage of critical skills that constrains investment in some industries. Reducing the mismatch between output and demand structures requires not only demand-side policies, but also supply-side policies. In particular, removing policy distortions that favor the production of tradables over nontradables will do as much to reduce the mismatch as boosting demand.

While developing Asia has played a part in the emergence of global imbalances since the Asian crisis, an orderly unwinding of those imbalances will require a global effort. In this context, an especially significant global initiative would be the reform of the global financial architecture. Many commentators in developing Asia feel that IMF did a poor job of handling the Asian crisis of 1997–98. Right or wrong, this view has eroded confidence in the institution throughout the region. This, in turn, may have encouraged regional countries to run up current account surpluses to build up a large war chest of foreign exchange reserves that would protect them from another devastating crisis in the future. Measures to restore the region's confidence in IMF, such as governance changes that would give the region a voice proportionate to its role in the world economy, would weaken the incentives for precautionary reserve buildup and thus contribute to global rebalancing.

By far the most important message of this part of *ADO 2009* is that it is fundamentally in developing Asia's own enlightened self-interest to rebalance the structure of its demand toward domestic sources. Part of

the need for rebalancing is driven by short-term necessity—rebalancing will help to mitigate the sharp slowdown in exports and growth due to the synchronized slump of the G3 economies.

Looking further ahead to the medium and long term, while the global crisis does nothing to diminish the benefits of an outward-looking export-oriented growth strategy, it does highlight the very real risks of an excessive reliance on external demand. It is true that Asian rebalancing would contribute to an orderly unwinding of global imbalances, which is a global public good.

However, the region has the best reason of all to pursue rebalancing: its own growth and welfare. The region is in a good position to pursue rebalancing because it has much stronger fundamentals than it did during the Asian crisis. These include relative good health of the financial sector and generally strong fiscal positions.

A further argument for rebalancing Asia's growth is that many of the policies rebalancing requires are consistent with and in fact supportive of the broader objectives of poverty reduction and inclusive growth. For example, strengthening health care and old-age support not only helps to boost domestic demand, but also to reduce poverty and inequality to the extent that the poor suffer disproportionately from lack of access to such basic services.

Rebalancing can also give a large boost to intraregional trade. While intra-Asian trade has superficially experienced impressive growth in recent years, much of it is trade in intermediate goods geared toward exporting final goods to countries outside the region. More robust domestic demand for final goods within regional countries will allow for more substantive intraregional trade along the lines of the European Union. As the region's incomes rise, consumers will demand more product variety and this demand will create a greater potential for intra-industry trade (that is, trade in which a country simultaneously imports and exports similar products) in differentiated products among regional countries.

Saving, investment, and current account surplus in developing Asia

The recent transformation of developing Asia into a current account–surplus region is puzzling. Prior to the 1997–98 Asian financial crisis, the region as a whole ran current account deficits, with its high saving rates surpassed by even higher investment rates. On the surface, there would still seem to be significant scope for expanding productive investment in the region to raise incomes and reduce poverty. Yet in recent years, developing Asia has become a net exporter of capital. Considering the continued needs of the region, why have investment rates in some Asian countries dropped in the post–Asian crisis period? Also, in light of sharply reduced investment rates, why have saving rates remained buoyant? These questions are especially pertinent for the more advanced economies of East and Southeast Asia, which account for the bulk of developing Asia's current account surplus.

One explanation for Asia's large and persistent current account surpluses centers on the investment rate. This school of thought argues that the fall in investment rates is an anomalous phenomenon that cannot be explained by economic fundamentals. That is, post–Asian crisis investment rates are now "too low". This implies that various policy distortions restrict investment and hence growth to levels below those that prevailed prior to the Asian crisis.

If this hypothesis is correct, the key to restoring investment and growth is to remove the various policy distortions that shackle entrepreneurship and risk-taking. However, other analysts contend that precrisis investment rates were "too high" and that current rates thus better reflect economic fundamentals. Under this alternative hypothesis, poor corporate governance and other market failures led to overinvestment and misallocation of resources. The logical corollary is that the investment drop-off after the Asian crisis is a return to more desirable and sustainable levels of investment.

Another explanation of the recent current account imbalances centers on whether saving rates have been optimal. Even before the Asian crisis, there was a widespread perception that Asian saving behavior was unique. Noneconomic factors such as culture were put forth as explanations for why Asian saving was high relative to other parts of the world (for example, Hayashi 1997). The fact that Asian saving rates held up well after the Asian crisis despite the decline in investment rates has given further credence to this view. Of particular interest is the saving rate of the PRC, which is astonishingly high, given the country's per capita income level.

The issues of whether Asia is saving too much or is investing too little are not mutually exclusive. Both may deviate from the rates that would be suggested by underlying economic fundamentals, such as the level of income, national demographic data, and rates of growth.

However, the distinction matters since the policy prescriptions for resolving underinvestment are fundamentally different from those for addressing oversaving. To the extent that developing Asia's current account surplus is driven by suboptimal saving and investment levels, the region can achieve efficiency gains or improve social welfare by improving policies that shift investment or saving rates toward their optimal levels. Pinpointing the main sources of the imbalances will help identify the most effective way for developing Asia to contribute to the unwinding of global imbalances.

Trends in developing Asia's saving and investment

East and Southeast Asia's high saving rates have often been attributed to noneconomic factors. In particular, there is a view that the region's saving rates reflect a culture that places a premium on thrift—making sacrifices today for a better tomorrow. In fact, the East and Southeast Asian economies had two fundamental pro-saving policies that differentiated them from other developing countries. One was sound macroeconomic management that prevented inflation and hence negative or variable real rates of return on deposits. The other was relatively strong prudential regulation and supervision which enhanced deposit safety. These economies also pursued various policies for promoting investment. Their governments were very successful in setting up the infrastructure—roads, ports, airports, power plants, water supply—that raises the rate of return on private investment, thus encouraging its expansion.

As noted earlier in *Causes and consequences of global imbalances: Developing Asia's perspective*, the advent of developing Asia's current account imbalances differed across economy groups depending on how the underlying saving–investment imbalances evolved (Figure 2.3.1). Among the Asian crisis–affected countries, such as Korea and Thailand, investment rates fell sharply while saving rates remained stable. The post–Asian crisis investment decline shifted the current account balance from deficit to surplus in these economies. In contrast, the other NIEs—Hong Kong, China; Singapore; and Taipei,China—had current account surpluses before the Asian crisis.

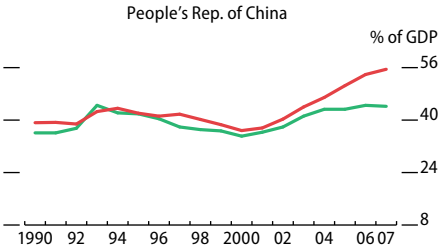
Recent expansions of these surpluses can be traced to both rising saving rates and falling investment. The current account deficit economies of India and Viet Nam have increased saving rates in recent years, but these increases have been offset by even more rapid increases in investment. Finally, in the unique case of the PRC, a low-income current account surplus economy, investment rates remained elevated in the post–Asian crisis period, but the saving rates have surged even higher since 2003. The widening current account surplus is driven almost exclusively by high saving rates.

To better understand how the saving–investment balance has evolved, it is useful to study individual country experiences. Of particular interest is whether the Asian crisis significantly changed behavior in the region. Such effects are likely to be most pronounced in the countries that it hit hardest. However, it is conceivable that neighboring countries may

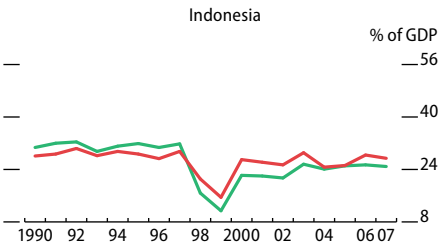
2.3.1 Saving and investment rates of individual Asian economies

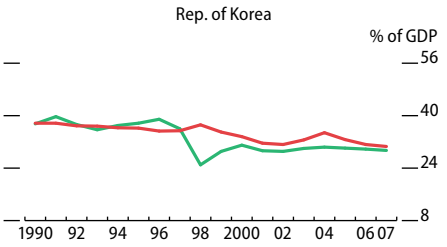
Saving — Investment

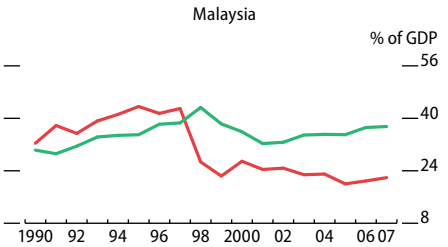
A. Low-income current account surplus economy

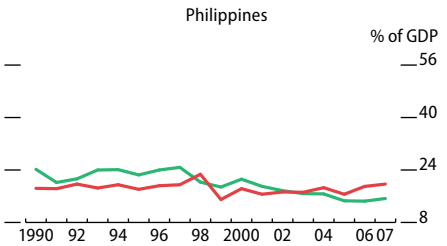


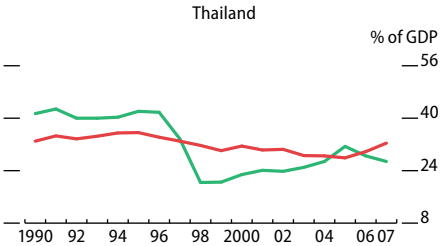
B. Asian crisis–affected economies



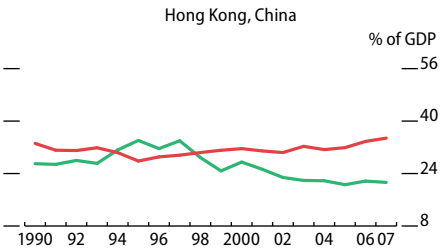


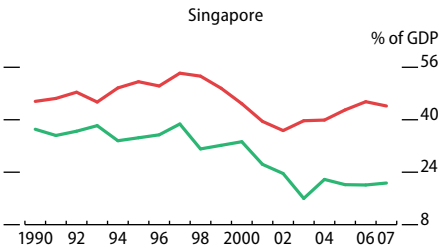


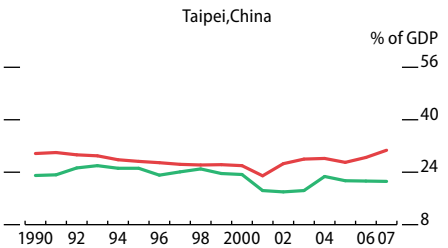




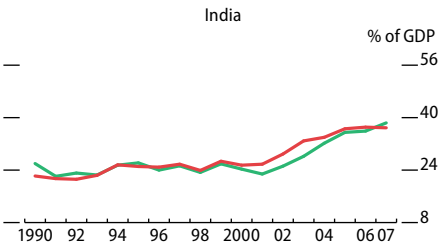
C. Other newly industrialized economies

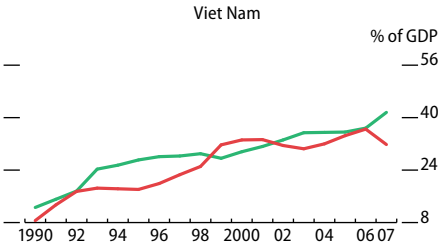






D. Other low-income emerging economies





Sources: Asian Development Bank, *Statistical Database System*; CEIC Data Company Ltd., both downloaded 10 January 2009.

Click here for figure data

have also changed their behavior because of the psychological impact of witnessing the effects of the sharp contraction.

Empirical framework

To determine whether saving and investment rates are "too high" or "too low", the rates that could be explained by economic fundamentals must first be established. Strictly speaking, an econometric model of saving and investment can only tell us which variables are important in explaining the observed rates rather than what is optimal (in an efficiency- or welfare-maximizing sense). Nevertheless, taking into account the main factors affecting saving and investment behavior shows the rates that would be predicted by the underlying economic fundamentals. For example, even if a country's saving rate is higher than average, the rate may be appropriate for its income level. In that sense, the rates predicted by economic models give an approximation of the "right" saving and investment rates. Deviations from the rates predicted by fundamentals can be interpreted as evidence of over- (under-) investment and over- (under-) saving.

Modeling investment behavior

In economic growth theory, the expansion of the capital stock parallels the growth of output in the long run. This suggests that per capita output growth will be an important determinant of investment.[10] Productivity growth that is driven by technological shocks, improvement in corporate governance, reallocation of factors from low- to high-productivity sectors and other structural changes, are the primary drivers of long-run output growth. In the short run, positive demand shocks that raise profitability will encourage investment. Financial market imperfections that increase the relative importance of internal funds in financing investment also suggest a positive effect of output growth on investment.

A well-established stylized fact lends strong support to the hump-shaped relationship between the level of per capita income and the investment rate. The marginal returns to capital are low in poor countries due to the absence of complementary factors of production such as human capital and good governance. The marginal returns to capital rise as income rises because of an increasing supply of such complementary factors. As a result, income begins to catch up with that in rich countries. However, after the catch-up is complete, and the catch-up country has itself become a mature, rich economy, diminishing marginal returns set in.

As Kim and Lee (2008) point out, demographic factors also influence investment. Slower growth of the working-age population slows economic growth, which reduces the returns to investment. In the absence of technological progress and other structural changes that raise labor productivity, investment will fall. In the short run, however, it is possible that firms will invest more to substitute capital for labor as a means of coping with the growing shortage of labor. IMF (2005) argues that higher youth dependency ratios increase the demand for infrastructure investments due to a growing labor force as well as investments related to human capital accumulation, such as schools. However, an aging

population slows down growth of the labor force and thus the demand for infrastructure.

The theoretical impact of financial development on investment is positive (Ito and Chinn 2007). Financial development promotes investment by lowering the cost of capital and the risk of investment. The literature highlights mitigation of information asymmetries, the reduction of information and transaction costs, the improvement of corporate governance, and facilitation of risk management as potential channels (for example, Levine 2005).

The empirical literature using cross-country data to estimate investment rates is sparser than the literature on saving rates. In an empirical study using a panel data set of more than 100 economies, Higgins (1998) finds that both youth and old-age dependency ratios have a strong negative effect on investment, and that the demographic effects are quite large. IMF (2005) finds a significant and positive effect of per capita GDP growth on the investment rate. More precisely, that study's results indicate that a 1 percentage point increase in per capita GDP growth raises the national investment rate by 1.6% in industrial countries and by 1.0% in developing countries.

A more recent study by Bosworth and Chodorow-Reich (2007), which uses a panel data set of 85 economies covering 1960–2005, finds a strong negative relationship between both dependency rates and investment rates. The same study also finds a strong positive effect of per capita GDP growth on investment rates. Ito and Chinn (2007) fail to find any clear evidence of either a positive or negative impact of financial development on investment rates.

Modeling saving behavior

Richer countries tend to save more than poorer countries, and faster-growing countries tend to save more than slower-growing countries. Intuitively, this makes sense since the average household in poor countries will tend to save less of its income than the average household in rich countries due to its lower consumption level and higher marginal utility of consumption. Further, economic growth boosts the income of the working-age population, which tends to save, relative to the retiree population, which tends to dissave, pushing up aggregate saving in the process.

According to the life-cycle hypothesis, which lies at the core of saving theory, individuals save when they are working and use up their savings after retirement. A high old-age dependency ratio implies that the number of those who are dissaving rises relative to the number of those who are saving, and thus reduces aggregate saving. A high youth dependency ratio implies that those who are working have to provide for the material needs of large numbers of children, thus reducing their capacity to save.

Higher dependency rates can also have adverse consequences for the government budget balance and hence public savings. A smaller workforce generates lower tax revenues, and a high youth dependency ratio requires large spending on child care and education. More significantly, a higher old-age dependency ratio calls for greater outlays for the elderly, such as pensions and health care. Workers will also adjust their saving behavior depending on their expectations for retirement. Life

expectancy can be used as a proxy for the length of the retirement period. The longer people expect to live, the longer they foresee their retirement period. This implies a greater need for postretirement income to be financed by higher saving during working years.

As Ito and Chinn (2007) point out, the effect of financial development on saving is ambiguous. According to the more traditional view, typified by Edwards (1996), financial deepening induces higher saving by creating deeper and more sophisticated financial systems. Alternatively, more developed financial markets could lessen the need for precautionary saving, and thereby reduce the saving rate.

There is a large empirical literature that uses cross-country data to estimate the relationship between saving rates on one hand and economic and demographic variables on the other. This literature finds two economic variables—the level of per capita income and its growth rate—to be particularly significant determinants of saving rates. For example, empirical analysis by IMF (2005) finds that a 1 percentage point increase in per capita income growth raises the national saving rate by 1% in industrial countries and 0.5% in developing countries. Bosworth and Chodorow-Reich (2007) also find that the growth rate of per capita income has a significant and positive effect on saving rates.

A large number of cross-country empirical studies have established a negative and significant impact of demographic variables—such as youth and old-age dependency ratios—on saving rates. These include Kim and Lee (2008), Bosworth and Chodorow-Reich (2007), IMF (2005), Luhrmann (2003), and Chinn and Prasad (2003). With respect to the impact of financial development on saving, Ito and Chinn (2007) fail to find any definitive evidence, other than that the impact depends on the degree of capital account liberalization and legal and institutional development.

Empirical framework

Kim and Lee (2008) point out that most of the large empirical literature investigating the impact of demographics on saving uses a cross-country framework, though a few studies use household survey data.[11] Macroeconomic studies combine time-series data and a broad cross-section of countries to estimate the impact of demographics on saving. The relatively limited number of studies that estimate investment rates using such panel data sets estimate both saving and investment rates with basically the same empirical model. The main examples of this last approach are Bosworth and Chodorow-Reich (2007), IMF (2005), and Higgins (1998).

The empirical model of saving and investment used in this section is based on Bosworth and Chodorow-Reich (2007) which, in turn, was based on Higgins (1998). The main difference between the Bosworth and Chodorow-Reich model and the IMF model is that the IMF model uses more explanatory variables. Due to the difficulty in finding comparable cross-country data for many indicators, the IMF approach has a much smaller sample size—46 economies compared to the 85 covered by Bosworth and Chodorow-Reich.

As in Bosworth and Chodorow-Reich (2007) and IMF (2005), the choice in this part of *ADO 2009* to use relatively simple linear reduced

forms rather than a structural model is dictated by practical econometric considerations, in particular data availability. The analysis here limits the main explanatory variables to those previously discussed: per capita GDP and its growth rate, demographic variables, and level of financial development. By following a parsimonious estimation strategy—as in the Bosworth and Chodorow-Reich approach—this analysis expands the sample size to cover 137 economies in the saving estimates and 141 in the investment estimates. Including a larger number of countries gives a clearer picture of the appropriate saving and investment rates. The details of the estimation approach are provided in Box 2.3.1.

2.3.1 The empirical model

The model of saving and investment tested in this part of *Asian Development Outlook 2009* is based on Higgins (1998) and Bosworth and Chodorow-Reich (2007). Those models assume that saving and investment rates are influenced by three sets of variables: country-specific factors that change over time (X_{it}), factors that vary across countries but not over time (C_i), and the demographic structure of the population (P_{it}). The basic forms of the empirical specifications are as follows:

$$S_{it} = S(X_{it}, C_i, P_{it}) + u_{it} \quad (1)$$

$$I_{it} = I(X_{it}, C_i, P_{it}) + v_{it} \quad (2)$$

The estimations provided in this part are from Park and Shin (2009). The data combine the time series of macroeconomic indicators of countries in a panel. There are 137 economies for the saving model estimates and 141 economies for the investment model estimates. For both, 12 economies are from developing Asia: Bangladesh; PRC; Hong Kong, China; India; Indonesia; Korea; Malaysia; Pakistan; Philippines; Singapore; Sri Lanka; and Thailand. The data refer to 1965–2004. In general, 5-year averages are used, except for the two periods around the Asian financial crisis. In this case, the averages refer to the periods 1990–1996 and 1997–1999.

Both saving and investment model estimations include the current and previous period's GDP growth rates, real per capita GDP and its squared value to allow for nonlinearities, a proxy for financial development, and a set of demographic variables. The table below presents the main variables used in the analysis, their sources, and their definitions. Additional variables are included in some regressions for examining the effect of the Asian crisis on saving and investment behavior.

A binary variable equal to one for the most affected countries (Indonesia, Korea, Malaysia, Philippines, and Thailand) and zero otherwise is included in some regressions. Other regressions include this variable interacted with binary variables for each period.

Both fixed-effects and random-effects estimation techniques are used. The former control for country-specific factors. The underlying empirical analysis thus concentrates on how the explanatory variables affect saving and investment over time. The latter control for time effects. The underlying empirical analysis thus concentrates on differences in saving and investment behavior across countries.

Sources and definitions of variables

Variable	Source	Definition
Saving ratio	WDI	Average ratio of gross national saving to GDP for each period
Investment ratio	WDI	Average ratio of gross domestic investment to GDP for each period
Real per capita GDP	PWT	Average of purchasing power parity–adjusted real per capita GDP at the beginning of each period
Real per capita GDP growth	PWT	Average annual growth rate of real per capita GDP for each period
Financial development	IFS	Average ratio of broad money (M2) to nominal GDP for each period
Old-age dependency ratio	WDI	Average ratio of population aged 65 and over to the population aged 15–64 for each period
Youth dependency ratio	WDI	Average ratio of population aged 14 and under to the population aged 15–64 for each period
Life expectancy	WDI	Average expected life span at birth in years for each period

Sources: International Monetary Fund, *International Financial Statistics* (IFS) online, downloaded 8 January 2009; A. Heston, R. Summers, and B. Aten, Penn World Table (PWT) Version 6.2, Center for International Comparisons of Production, Income and Prices at the University of Pennsylvania, September 2006; World Bank, *World Development Indicators* (WDI) online, downloaded 8 January 2009.

Is developing Asia investing too little?

The investment model estimations show a strong positive relationship between investment rates and GDP growth, both current and lagged (Table 2.3.1). This result holds even when the estimates are made for Asian countries and non-Asian countries separately. When the estimates include all countries, the model predicts that investment rates will rise with per capita income, but at a decreasing rate, reaching their peak when national income is about $19,000. Interestingly, the per capita income variables are not statistically significant for the subsample of Asian countries. Growth seems to be the driving factor behind developing Asia's relatively high investment rates—which is also reflected in the much higher coefficients for GDP growth in the Asian subsample.

2.3.1 Dependent variable: Investment rate, country fixed effects

	All economies	Asia	All economies minus Asia
GDP growth	**0.258**	**0.838**	**0.232**
Lagged GDP growth	**0.250**	**0.700**	**0.229**
Per capita income	**0.335**	0.140	**0.361**
Per capita income squared	**-0.017**	-0.006	**-0.019**
Life expectancy	0.039	0.077	0.039
Old-age dependency	**-0.568**	*-1.695*	*-0.450*
Youth dependency	*0.056*	**-0.297**	**0.069**
Financial development	-0.005	*-0.053*	-0.004
Observations	783	84	699
R-squared	0.19	0.78	0.13

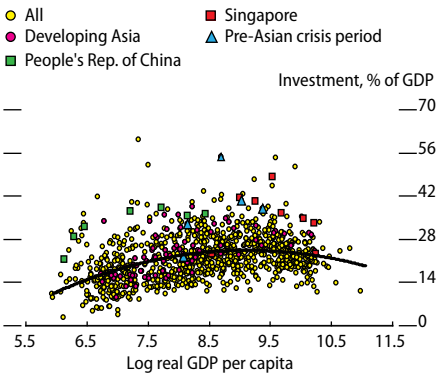
Note: Bold denotes significance at the 1% level; italics denote significance at the 5% level.

Source: D. Park and K. Shin. 2009. "Saving, Investment and Current Account Surplus in Developing Asia." Background paper prepared for *Asian Development Outlook 2009*. Asian Development Bank, Manila.

The impact of financial development is only statistically significant in the Asian subsample where it is preceded by a negative sign. This is unexpected since financial development improves the access of firms to financing and thus promotes investment. However, in the case of Asia, if financial underdevelopment did in fact lead to too much investment, then improved financial development could have raised the quality of investment, even while its quantity declined.

To see what underlies the regression results, Figure 2.3.2 plots the data for all economies and all periods according to investment rate and per capita income. The curve in the figure denotes the "appropriate" investment level, based on the estimation results using the full sample, but only including per capita income and its square. As the figure shows, most Asian countries are clustered around the fitted line, suggesting that their investment rates are appropriate to their income levels. Only the PRC and Singapore show some signs of persistent overinvestment relative to their income levels. Interestingly, the five Asian crisis–affected countries also display evidence of investing too much in the period immediately preceding the 1997–98 contraction.

2.3.2 Investment rates by per capita income, full sample



Note: All variables are 5-year averages of eight subperiods, beginning with 1965–1969 and ending in 2000–2004.

Sources: A. Heston, R. Summers, and B. Aten, Penn World Table Version 6.2, Center for International Comparisons of Production, Income and Prices at the University of Pennsylvania, September 2006; World Bank, *World Development Indicators* online database, downloaded 14 February 2009.

Click here for figure data

To what extent can the seemingly anomalous investment behavior of the PRC and Singapore be explained? The model was estimated including country indicator variables for the PRC and Singapore to see if there was a statistically significant deviation from the "appropriate" investment level, once their economic and demographic characteristics were taken into account. The results indicate that most (65–70%) of the deviation from the average per capita income/investment rate profile was explained by the model for these countries, but with some residual overinvestment.

For the five Asian-crisis affected economies, country indicator and time-period variables were included to capture the effect of the crisis on investment behavior. The results provide stronger support for the hypothesis of overinvestment prior to the Asian crisis rather than underinvestment in the wake of this disruption. The evidence of pre–Asian crisis overinvestment is stronger for Malaysia and Thailand than for Indonesia, Korea, and Philippines.

The diversity of the Asian crisis–affected countries should be kept in

mind when considering the implications of the decline in investment. For example, Malaysia and Thailand are middle-income countries that are seeking to move up the global value chain by shifting their output structure away from labor-intensive goods to skills-, capital-, and technology-intensive goods. Therefore, investment in those two economies is complicated by ongoing structural changes, and depends on an adequate supply of complementary factors such as skilled labor.

Korea, as a more mature high-income economy, differs from the other four crisis-affected countries as diminishing returns to capital may have already set in. In such conditions, the decline in the investment rate in Korea is least likely to reflect underinvestment. Finally, Indonesia and the Philippines are at income levels at which one can expect high marginal returns to capital. However, deep-seated structural weaknesses in the investment climate, such as inflexible labor markets, poor infrastructure, and weak governance, may be holding back investment and keeping growth below its potential.

While the empirical results do not find evidence of underinvestment in developing Asia, this finding should be interpreted with caution due to data limitations. First, it would be useful to have more disaggregated investment data to see if this finding holds. For example, it would be interesting to see how different types of investment—such as plant and equipment versus buildings and land improvements—behaved before and after the Asian crisis. Another line of inquiry would be to look at firm- or industry-level investment data rather than national investment. Here, a number of studies using data from firms in Korea support the view of overinvestment prior to the Asian crisis (for example, Hong, Lee, and Lee 2007; and Ryou and Kim 2003). Similar analysis of other Asian crisis–affected countries would be useful to better understand recent investment rate trends.

Another set of data limitations includes missing explanatory variables that intuitively should influence investment. For example, political stability and rule of law would be expected to affect a firm's decision to invest, as is the quality of public investment in infrastructure. Last, using the ratio of broad money to GDP as a proxy for financial development may not accurately capture differences in the quality of financial intermediation across countries.

With these caveats in mind, the lack of empirical evidence on underinvestment does not imply policy inaction. The optimal level of investment will depend on the business environment. Firms may be making the appropriate amounts of investments given the constraints they face, but mitigating those constraints will unleash the full investment potential of the private sector. For example, financial underdevelopment deprives firms of instruments to adequately cope with the risk and uncertainty, which are intrinsic components of any investment. Investment may be more or less optimal given the low level of financial development, but in this case the more fundamental policy challenge is to speed up financial development, which, in turn, will help improve the investment environment.

To cite another example, if labor market rigidities or poor infrastructure lower the returns to investment, the private sector may be investing at optimal levels (given such investment-climate impediments), but the relevant policy challenge is to alleviate such impediments so

as to unleash potential investment. A recent study (Schou-Zibell and Madhur 2008) finds that the investment climates of Indonesia, Malaysia, Philippines, and Thailand still lag far behind those of the NIEs and industrial countries.

Changes in corporate structures were made in the Asian crisis–affected countries as part of their recovery from the 1997–98 contraction. Implicit government guarantees for investments and poor corporate governance (such as cross-subsidies between component firms of a conglomerate) may have encouraged firms to take risks and hence to make investments in the precrisis period. While such distortions might have led to overinvestment, they were nevertheless a mechanism for companies to cope with risk and uncertainty. After the Asian crisis, improved public and corporate governance may have created a vacuum in risk-coping mechanisms.

While an efficient financial system would provide tools for firms to cope with uncertainty, developing Asia's financial systems continue to lag development of the real economy. Developing broader, deeper, more liquid financial markets—in other words, financial development—would help revive investment momentum (Box 2.3.2).

2.3.2 Financial development and quality of investment

Financial development can enhance the quality of investment through several channels. First, it can help increase the amount of funds available for investment by pooling savings and allocating these funds to productive investment projects. Financial intermediaries can economize on the costs of collecting savings from heterogeneous saving units by exploiting economies of scale in information gathering and processing. Second, it can reduce liquidity risks (Diamond and Dybvig 1983). While investment often requires the commitment of a large amount of capital for a long period, individual savers are reluctant to lend long term because they prefer to maintain a comfortable degree of liquidity in their asset portfolios. Financial institutions that inherently borrow short term and lend long term help alleviate this dilemma.

Financial intermediaries play an important role in reducing the costs of acquiring and processing information concerning prospective investment activities (Diamond 1984). Well-developed financial institutions provide information about the profitability of investment activities and monitor the management of borrowing firms. While a dispersed pool of investors cannot effectively monitor the use of their funds, financial institutions can play the role of "delegated monitor." This encourages investors to part with their savings and allocate resources toward more productive investments. The result is a higher volume of investment, as well as more efficient allocation of capital.

Capital market development, especially development of a well-functioning stock market, can improve the quality of investment by exerting pressure on corporate management (Stiglitz 1985). Such pressure often takes the form of actual or potential takeover, which maintains diligence among corporate managers and induces them to use funds in their care effectively. In particular, stock markets promote corporate governance by linking managerial compensation to the firm's performance.

Financial liberalization, a core element of financial development, can bring about more efficient allocation of capital across countries, and facilitate international portfolio diversification and risk sharing. Legal and other institutions define the context in which financial transactions and economic decisions are made (Ito and Chinn 2007). An appropriate legal system enforces law and order, minimizes corruption, and protects property rights, thereby stimulating saving and investment. Levine et al. (2000) find that cross-country differences in legal and regulatory systems influence the level of financial development.

Finally, inadequate prudential supervision and regulation limit the contributions of financial institutions in enhancing the level and quality of investment. For example, too close a relationship between the financial and corporate sectors can stifle competition in credit markets and lead to deterioration of investment quality. Similarly, rapid growth of the stock market without appropriate regulatory oversight over insider trading and other rent-seeking activities dilutes its role as a catalyst for better corporate governance. To conclude, financial development can promote better investment as well as a higher level of investment in the region.

Is developing Asia saving too much?

GDP growth has a strong impact on behavior in all saving-model estimates, with a significant impact from the previous year's growth also evident in the Asian subsample. Faster-growing countries are likely to save and, as shown in the previous subsection, invest more than slower-growing economies. The relationship with per capita income is less clear. For the non-Asian countries, the pattern is similar to investment: the saving rate increases with income but at a decreasing rate. Among Asian countries, saving is estimated to increase with income (over the relevant range of per capita GDP). The net result when the countries are pooled is that there is no statistically significant relationship between saving rates and per capita income (Table 2.3.2). Demographic variables also affect saving, but again, the effects are different for Asian and non-Asian countries, with old-age dependency the key variable for non-Asian countries, but youth dependency relevant for Asia. This is likely due to the relatively young populations in the Asian sample throughout the data period.

2.3.2 Dependent variable: Saving rate, country fixed effects

	All countries	Asia	All countries minus Asia
GDP growth	**0.354**	*0.563*	**0.371**
Lagged GDP growth	0.122	*0.469*	0.121
Per capita income	0.092	**-0.447**	**0.261**
Per capita income squared	0.000	**0.032**	-0.011
Life expectancy	0.054	*0.197*	0.046
Old-age dependency	**-0.985**	-1.230	**-0.764**
Youth dependency	0.028	*-0.215*	0.033
Financial development	-0.003	-0.034	-0.001
Observations	724	83	641
R-squared	0.18	0.53	0.15

Note: Bold denotes significance at the 1% level and italics denote significance at the 5% level.

Source: D. Park and K. Shin. 2009. "Saving, Investment and Current Account Surplus in Developing Asia." Background paper prepared for *Asian Development Outlook 2009*. Asian Development Bank, Manila.

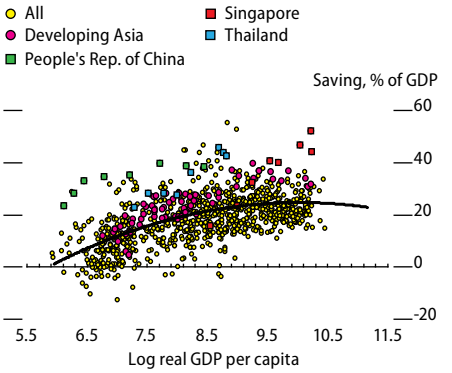
Looking at a plot of the saving rate data against per capita income, PRC, Singapore, and Thailand seem to be outliers (Figure 2.3.3). When the model was estimated with indicator variables for these countries to see the amount explained by economic and demographic characteristics, the results were very different from the investment behavior estimates. For the PRC in particular, fundamentals explain only 22%, suggesting the country is saving too much. For Singapore and Thailand, a substantial unexplained portion of saving also remains (42% and 33%, respectively). For the Asian crisis-affected countries, there is some evidence of oversaving since the mid-1980s, and the rate of oversaving intensified during the 1997–98 crisis.

The key finding emerging from the empirical analysis is evidence for oversaving in the five countries that were hardest hit by the Asian crisis. Even in those countries—where it was widely believed that the postcrisis decline in investment reflected underinvestment—there was instead stronger evidence of postcrisis oversaving.

However, a closer look at the evidence suggests that the results should be interpreted with caution. The coefficients for the country indicator variables for the crisis-affected countries become larger after the Asian crisis. A plausible interpretation is that precautionary saving may have increased since the crisis. Given the wrenching socioeconomic havoc wrought by the crisis, both households and firms have had a strong incentive to save more for contingencies. The heightened post–Asian crisis caution is a perfectly rational response to the experience suffered, and this weakens the case for equating unexplained saving as oversaving.

By the same token, it would be inappropriate to interpret the fact that fundamentals cannot explain much of the PRC's saving behavior as prima facie evidence of oversaving. In the PRC and elsewhere, firms and households may be saving optimally given the constraints they face, such as financial underdevelopment.

2.3.3 Saving rates by per capita income, full sample



Note: All variables are 5-year averages of eight subperiods, beginning with 1965–1969 and ending in 2000–2004.

Source: As figure 2.3.2.

Click here for figure data

Concluding remarks: Implications for global imbalances

While the change in both saving and investment rates contributed to the development of large, persistent current account balances, the empirical results point to saving as the main contributor to developing Asia's large persistent current account surpluses. The 1997–98 Asian financial crisis was a critical turning point for the region: it generated chronic current account surpluses only since its recovery from the crisis. Because of this, the postcrisis decline in investment rates in the five countries hardest hit by the Asian crisis—Indonesia, Korea, Malaysia, Philippines and Thailand—is sometimes viewed as evidence of underinvestment in those countries. The implication is that their current account surplus is caused by suboptimal investment levels.

However, the analysis finds stronger evidence of overinvestment in the precrisis period than of underinvestment today. The postcrisis drop-off in investment rates may mark a return to more sustainable investment levels from unsustainably high levels during the precrisis period. However, this result needs to be viewed cautiously due to the limitations of the empirical analysis.

The empirical results show stronger evidence of oversaving in Asia since the crisis. One possible interpretation is that painful memories of the devastating Asian crisis encouraged Asian households and firms to save more, as a precaution. The evidence also indicates that economic fundamentals and demographics cannot account for the exceptionally high saving rates in the PRC. The results imply that policies aiming to increase consumption will contribute more effectively to unwinding global imbalances than those promoting investment.

However, in the Asian crisis–affected countries, the increase in consumption should not come at the expense of investment. That the empirical analysis could not find evidence of either under- or overinvestment in these countries suggests that investment is close to its appropriate level. Therefore, consumption that displaces investment may move consumption toward its optimal level, but move investment away from its optimal level. The implication for policy makers is that they should avoid policies that promote consumption at the expense of investment. This policy prescription is less relevant for the PRC and Singapore, where the analysis finds some preliminary evidence of both oversaving and overinvestment.

Rebalancing growth: The role of saving and consumption

The evidence from the earlier subsection, *Is Developing Asia saving too much?* requires a closer look if one is to understand what lies behind oversaving behavior in individual countries. Saving has two key functions: supporting growth and enhancing welfare. First, it finances investment in a country, particularly where there are limited opportunities to borrow from abroad. Second, the accumulated wealth from saving can finance consumption during periods of scarcity, helping smooth consumption over a person's lifetime.

Yet, as previously discussed, there are limits to the benefits from saving. At some level, welfare could be enhanced if people consumed more today than in the future. Saving beyond what an economy invests gets channeled overseas. However, evidence supporting this practice is limited in developing Asia (Fujiki and Terada-Hagiwara 2007). For developing Asia, this has often been into safer, lower-yield government bonds. In an environment of oversaving, understanding the underlying behavioral dynamics will help design policies to redirect saving into consumption and investment. This will support a more balanced growth model for developing Asia, and ultimately better balanced global growth.

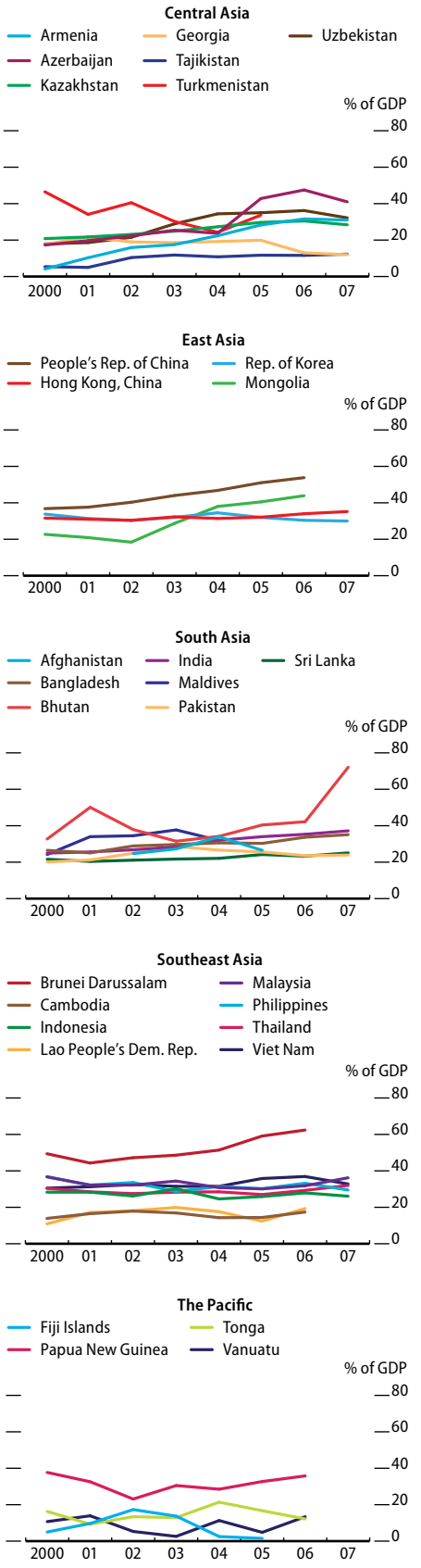
Composition of national saving

The economies in developing Asia that grew the fastest are also characterized by high saving rates, especially those that have consistently saved 30% or more of their GDP since the mid-1980s. In fact, the economies of Hong Kong, China; Indonesia; Korea; Malaysia; Singapore; Taipei,China; and Thailand have achieved high and sustained saving and growth rates since the mid-1970s. This observation is often described as the "virtuous cycles of saving and prosperity" as opposed to the "poverty trap" of inadequate saving and stagnation (Loayza et al. 2000).

But when the saving rate in an economy exceeds the investment rate, the social value of saving falls below its private worth. For most major economies in the region, saving rates have either increased or stayed roughly constant after the recovery from the Asian crisis. On average, current national saving rates are high in Asia, with the PRC leading the pack with its rate in excess of 50% of GDP in 2007. The PRC experienced the sharpest jump—almost 20 percentage points in the 7-year period 2000–2007. A comparison across countries in developing Asia shows that saving rates vary considerably from above 40% of GDP in Azerbaijan, Bhutan, Brunei Darussalam, PRC, and Mongolia to below 15% in Fiji Islands, Georgia, Tajikistan, Tonga, and Vanuatu (Figure 2.4.1).

For countries with excess saving that is not directed to investment or consumption, rebalancing growth will require that the source of oversaving determines the appropriate policy mix. Domestic saving in an economy comes from three different categories of economic agents,

2.4.1 Gross saving rates



Source: World Bank, *World Development Indicators* online database, downloaded 6 February 2009.

Click here for figure data

that is, households, enterprises, and government. Household saving is defined as the difference between household disposable income and household consumption expenditure. Retained earnings (profits that are not paid out as dividends) are counted as corporate saving. These can of course be used to internally finance investment projects (if retained earnings of all firms in a country equaled domestic investment financed by those retained earnings, the effect on the current account would be nil). Government saving includes amounts that are used to finance public investment. Unfortunately, a breakdown of saving data by these categories is available only in a handful of cases. Figure 2.4.2 tracks the evolution of the composition of saving in PRC; India; Korea; Philippines; and Taipei,China.

The PRC and India have a significant increase in the national saving rate from 2000 to 2007. Aggregating across the five Asian economies reveals that aggregate saving has risen from 14.8% of GDP in 2000 to 37.8% in 2007. But the striking feature is that by 2007, corporate saving became the dominant source of saving in the sample, accounting for about half aggregate saving. This mirrors the trend in industrial countries in which corporate saving has become the main source of private saving, rather than household saving (OECD 2007). The share of corporate saving in the PRC has increased markedly in recent years, accounting for more than half of national saving in 2006. In India and the Philippines, too, the share of corporate saving has doubled relative to GDP since 2000. An upward trend was discernible in Korea and Taipei,China as well.

India's high reliance on human capital, low capital–output ratio, and efficient utilization of physical capital have limited its dependence on foreign saving as a source of financing growth (Mishra 2006). Household and corporate saving have risen and government saving, which had been negative in 2000, was positive in 2007, partly as a result of implementation of rule-based fiscal policies. Moreover, a 1 percentage point increase in public saving increases aggregate saving by 0.67 percentage points, which signifies the need for prudent fiscal policies.

By far, household saving has remained the dominant source of national saving in India, amounting to about 20% of GDP since the early 2000s. The share of this component in overall national saving has declined in PRC, Korea, and Philippines but remained stable in Taipei,China. The trend observed in the PRC can be largely attributed to a declining share of household income in overall national income. In Korea and the Philippines, the rise in corporate saving was inadequate to offset the significant decline in the ratio of household saving to GDP. This led to a slight fall in the overall national saving rate in Korea.

A different perspective on household saving is provided by the saving rate relative to household disposable income rather than GDP. This is the relevant metric for understanding household saving behavior as it abstracts from changes in the distribution of national income between labor and capital. Figure 2.4.3 shows the household saving rates for PRC, Korea, and India. The figure shows data from the national accounts (which are incomplete and unavailable for recent years) for the aggregate economy as a share of disposable income. In the PRC, the household saving rate climbed rapidly during the high-growth years of this decade. Similarly, the household saving rate in India rose sharply over the last

2.4.2 Composition of savings

Sources: National Bureau of Statistics of China, *China Statistical Yearbook*, various issues, available: http://www.stats.gov.cn, downloaded 23 February 2009; S. Jha, E. Prasad, and A. Terada-Hagiwara. Forthcoming. "Saving in Asia: Issues for Rebalancing Growth." ADB Economics Working Paper Series. Asian Development Bank, Manila; Directorate General of Budget, Accounting and Statistics, available: http://eng.stat.gov.tw, downloaded 6 February 2009; CEIC Data Company Ltd., downloaded 6 February 2009.

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decade, from 20% of disposable income in 1998 to 32% in 2007. Indeed, India now seems to have the highest household saving rate among the Asian economies for which data are available. In contrast to the PRC and India, the household saving rate in Korea has fallen considerably, from nearly 30% in the late 1990s to 10% in 2007.

The cross-country comparison shows substantial differences across countries in the evolution of overall saving rates as well as the sources of national saving. The sharp increase in corporate saving and the evolution of the PRC's saving both play significant roles in influencing overall saving patterns in Asia.

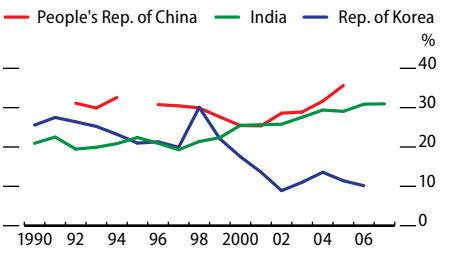
Determinants of corporate saving behavior

The jump in corporate saving in the available data suggests that this is an important contributor to developing Asia's rising saving rate. Corporate saving largely reflects retained earnings, which are linked to the profitability of firms. One way of classifying the determinants of corporate saving is to consider cyclical and transitory factors (for example, financial and monetary variables such as money supply, interest rates and inflation; the cost of investment goods and real estate prices) as well as long-term trends. Evidence from OECD countries shows that a quarter of the overall increase in aggregate corporate net lending (defined as the excess of undistributed profits or gross saving over fixed investment) between 2001 and 2005 can be attributed to the influence of the output cycle and one fifth to financial-sector buoyancy (OECD 2007). Global trends reflecting globalization and technological change as well as wage moderation led to a general long-term shift in profit shares in OECD countries.

What can account for the rising corporate saving in Asia? Unfortunately, detailed information on corporate accounts for most developing countries is rare. Limited data for PRC firms show that after-tax profits of the corporate sector (industry, retail trade, wholesale trade, and construction) rose by about 6% of GDP between 2003 and 2006 (OECD 2007). Robust economic growth, low interest rates, falling labor costs, and growing output prices significantly increased the profitability of state-owned and private enterprises (IMF 2005). High firm-level uncertainty—an incentive to reduce debt—and underfunding of company pensions encouraged larger cash holdings, which in turn added to saving.

Government policies helped further induce high corporate saving in the PRC. Massive state subsidies for land and energy to state-owned firms reduced their input costs substantially. Combining these subsidies with administrative monopolies in some cases led to high levels of profitability in the corporate sector, with the boom years generating rising profits until mid-2008. These profits produced large retained earnings (gross saving) owing to low dividend payout ratios (Tyers 2008). Until very recently, state-owned enterprises were not required to pay dividends to their shareholders or to the state, thereby creating an incentive for these firms to retain their profits rather than distribute them. When they are made, Lin (2009) argues that payouts from large and profitable firms go disproportionately to the rich, who have higher saving propensities than the poor, adding to the saving spiral.

2.4.3 Household saving rates



Notes: Household saving survey data for the People's Republic of China are based on per capita income and consumption, and on population, available from CEIC. Saving rates from national accounts (flow of funds) are expressed as a share of disposable income; the data are missing for 1990, 1991, 1995, 2006, and 2007. For India, data refer to gross savings of households as a share of personal disposable income. For the Republic of Korea, data refer to gross savings of individuals as a share of disposable income of households and private unincorporated enterprises.

Source: S. Jha, E. Prasad, and A. Terada-Hagiwara. Forthcoming. "Saving in Asia: Issues for Rebalancing Growth." ADB Economics Working Paper Series. Asian Development Bank, Manila.

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The underdeveloped financial system also has a role to play in the high level of retained earnings among profitable PRC firms. The financial sector is dominated by state-owned banks and the equity market, both of which favor large firms (Lin 2009). Similarly, Prasad (forthcoming) notes that the repressed financial system in the country provides capital at low real interest rates to favored firms, most of which are large state-owned firms, which increases profitability.

On the other hand, firms that are not favored have limited access to bank financing and face a lack of alternative financing mechanisms (for example, corporate bond markets), which leads them to retain their earnings in order to finance future investment projects. With the collapse of the equity markets in the early 2000s, companies switched to internal sources of finance rather than borrowing, creating a need to generate surpluses and to hold liquid assets, including cash, rather than pay out dividends (IMF 2006c).

In a fast-growing economy, retaining and reinvesting profits is an attractive proposition when firms face a very low opportunity cost of funds. More than 50% of total investment comes from corporate saving, not from borrowing. This also helps explain the high investment rates in the PRC—rates which have not been sensitive to interest rate fluctuations. Indeed, the surge in corporate saving went hand-in-hand with a rise in investment, notably in infrastructure, manufacturing, metals, automobiles, cement, and property. However, the quality of investment and overcapacity are matters of concern (IMF 2005).

Examining data for 1950–2005, Mishra (2006) notes that India's household saving rate is reaching a plateau and further contribution to private saving must come from corporate saving, which is among the lowest in the world (although firms report their saving net of depreciation allowance for tax purposes). Using data for 1950–2001, Sinha and Sinha (2007) find that the growth rate of GDP is a strong determinant of corporate saving in India. A number of policy initiatives too helped bolster corporate profitability (Mohan 2008). They included reduction in the corporate tax rate from 45% in FY1992 (year ended March 1993) to 30% by FY2005, the peak rate of customs duty on nonagricultural goods from 150% in FY1991 to 10% in FY2007, and sustained moderation in inflation leading to reduction in nominal interest rates. Firm-level factors included financial restructuring of firms, which led to a reduction in debt–equity ratios in the corporate sector and improved productivity and efficiency through new technology.

The literature on post–Asian crisis performance of corporate saving in NIEs is scant. However, Fernald and Neiman (2006) provide evidence that "favored firms" in Hong Kong, China; Korea; Singapore; and Taipei,China reaped economic profits during their rapid expansion in the 1990s. Preferential tax treatment, subsidies, and access to capital, which created market imperfections, led to favored firms' concentrated income growth, allowing them to maintain high saving rates. Similar observations on oligopoly rents, which increased profitability and corporate saving, have also been made in the context of the PRC by Lu et al. (2009) and Tyers (2008), and in a more general context by Aghion and Griffith (2005).

Determinants of household saving behavior

As the effects of the global slowdown permeate the Asian region and reduce corporate profitability, household saving could regain its dominance. Interestingly, even though household saving has declined as a share of national saving, it has continued to rise as a share of disposable income in the PRC and other countries. The rising household saving rate in the PRC is of considerable interest from two perspectives. First, this phenomenon plays a key role in explaining the rising current account surplus in the region. Second, understanding what is driving the rising household saving rate is crucial for devising policy measures for stoking private consumption growth. While the section, *Saving, investment, and current account surplus in developing Asia*, took a macro view of the determinants of saving, a micro view of household behavior is needed to fine tune policy.

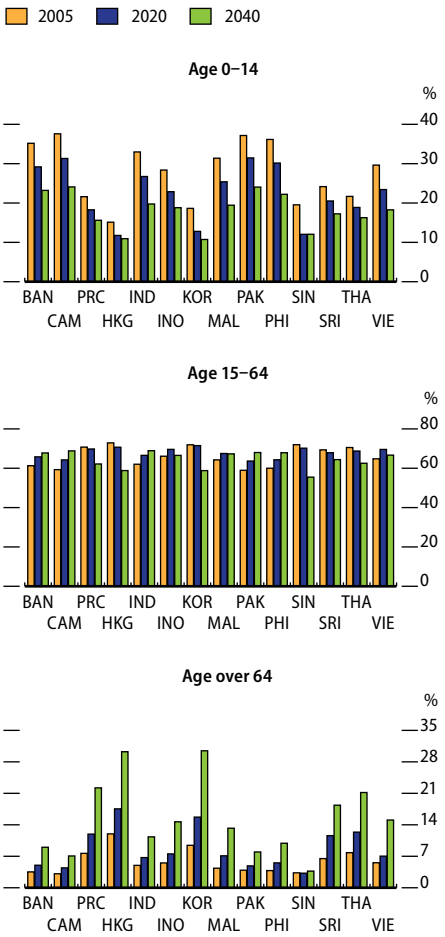
Several hypotheses of household saving behavior are particularly important for developing Asia, some of which are closely interlinked and complement each other.[12] The "life-cycle permanent income hypothesis" begins with the premise that individuals try to smooth their consumption based on their expected lifetime income. Since actual income is low in one's youth, consumption will exceed income and saving will be negative. During prime working years, individuals consume less than they earn, accumulating savings for retirement. Their assets are then run down after retirement. This hypothesis implies a hump-shaped age–saving profile. While empirical support for the hypothesis is weak, there is some supporting evidence from developing Asia in studies on Korea (Park and Rhee 2005), and Thailand and Taipei,China (Deaton and Paxson 2000).

The life-cycle hypothesis also implies a positive relationship between income growth and saving. Higher growth rates lead to higher saving rates as the working generation with faster income growth accumulates more saving than the amount of dissaving done by the retired generation. Attanasio and Szekely (2000) find that households in Taipei,China and Thailand save more because of higher income growth. Deaton (1997) also notes a positive relationship for Hong Kong, China; Indonesia; and Korea, in addition to the two aforementioned economies.

For a country as a whole, the life-cycle hypothesis implies a link between a country's saving patterns and its demography. An aging population means a rising dependency ratio (the ratio of children aged 0–14 years and the population beyond retirement age to those of working age) in the future. This should drive up the rate of saving today. Figure 2.4.4 shows demographic projections for selected Asian economies. The demographic transition in East Asian countries is noteworthy—an aging population with a declining fertility rate. The share of elderly in these economies is forecast to rise sharply, particularly for PRC; Hong Kong, China; and Korea. This could lead to greater saving rates today in anticipation of future high dependency ratios and strains on public pension systems. In contrast, the share of working-age population is expected to expand slightly over the next three decades in Bangladesh, Cambodia, India, Pakistan, and Philippines. This could reduce today's saving rates in anticipation of greater future earning capacity.

The implications of demographic change on the saving rate are not straightforward. The life-cycle theory posits that households headed by

2.4.4 Demographic projections (shares of dependent and working-age populations in total population



BAN = Bangladesh; CAM = Cambodia; PRC = People's Rep. of China; HKG = Hong Kong, China; IND = India; INO = Indonesia; KOR = Korea, Rep. of; MAL = Malaysia; PAK = Pakistan; PHI = Philippines; SIN = Singapore; SRI = Sri Lanka; THA = Thailand; VIE = Viet Nam.

Source: United Nations. *World Population Prospects: 2006 Revision Population Database*, available: http://esa.un.org/unpp/index.asp?panel=2, downloaded 25 February 2009.

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retired people would draw down their savings to finance postretirement consumption. This would generate a negative relationship between the old-age dependency ratio and saving rates. At the macroeconomic level, Kim and Lee (2007) find evidence of such a negative relationship in East Asia. At the household level, however, the relationship is not clear. Rising saving rates across all age groups and the high saving rates of the elderly cannot yet be explained by the life-cycle theory.

One possible explanation for this is that household surveys tend to undersample households near the top of the income distribution, who normally have high saving rates. This then results in lower household saving rates compared with the macroeconomic data. Another explanation relates to the factors driving family composition. In countries in which elderly people usually live with their working-age children, high household saving rates of households headed by older people could reflect family composition rather than high individual saving rates of the elderly, as pointed out by Deaton and Paxson (2000) and Attanasio and Szekely (2000). Clearly, aging of the population has complex effects on household saving.

Precautionary motives play an important role in explaining saving in less financially developed economies. Rising macroeconomic uncertainty or household risks can raise saving rates, in the absence of mechanisms for hedging against these risks. High saving rates among households with young household heads may be driven by the need to build an adequate buffer stock of savings to smooth consumption when hit by adverse shocks to their income, while households with older heads may be concerned about job loss and skills obsolescence. This could be particularly relevant for economies such as the PRC and Viet Nam that are becoming more market oriented, and where the level of household-specific employment and income uncertainty have risen, even though average income growth has been rapid.

One of the major factors inducing precautionary saving is an inadequate health care system. Health care financing in developing Asia is dominated by private expenditure, while public health systems remain weak and health insurance largely nonexistent—as the evidence from India highlights (Peters et al. 2002; Bonu et al. 2007). The availability of health insurance is particularly important for the elderly, who face rising health care costs.

In both the PRC and Taipei,China, precautionary motives have played an important role in household saving behavior. Indeed, in Taipei,China, provision of social health insurance is found to have substantially weakened the precautionary motive for saving. The 1995 introduction of the National Health Insurance scheme reduced household saving rates significantly, with declines of 9–14% in the average level of saving (Chou et al. 2003, 2006). In Taipei,China, Athukorala and Tsai (2003) conclude that increased availability of social security provisions and enhanced credit availability also tended to reduce household saving. In the PRC, precautionary saving has been triggered by the absence of a safety net, minimal health and education coverage, limited pension coverage, and low unemployment compensation funds or related benefits (Chamon and Prasad 2008).

The relationship between financial sector development and saving

behavior is complex. In general, use of financial instruments offers the household saver wide access to the yield on the investment opportunities available in the economy. Financial sector development can reduce the saving rates of households by reducing rate-of-return risks and by easing liquidity constraints through systematic development of consumer credit and mortgage markets. In particular, financial intermediaries and securities markets can help channel household saving to investment by providing liquidity to individual investors. Intermediated savings in general are likely to be more productive than when the household saver is limited to his or her own production technologies.

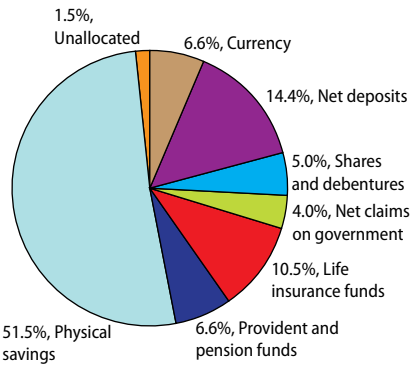
Alternatively, reliable access to borrowed funds through the financial system can reduce precautionary saving, allowing households to smooth their consumption—a temporary drop in income does not constrain their consumption. While the fact that the financial liberalization may have contributed to the decline in saving ratios in many industrial countries raises reservations, its benefits that arise from channeling saved resources to productive use and from higher welfare by smoothing consumption are important in many of the oversaving Asian economies.

Caballero et al. (2008) argue that financial sector underdevelopment and saving are related in three important ways as a driver of global imbalances, or oversaving in emerging economies. First, in a fast-growing economy in which the desired consumption bundle shifts toward durable goods such as cars and housing, inability to borrow against future income streams could lead to higher saving as households self-finance their purchases. Second, lack of diversification opportunities for financial assets could lead to greater precautionary saving. Third, financial repression, which results in low or negative real interest rates, could lead to higher saving—the real interest rate elasticity of saving could be negative if the income effect dominates the substitution effect. This is sometimes referred to as the "target saving hypothesis."

Evidence regarding the financial sector development link to saving behavior in developing Asia is mixed. In the case of India, the household saving rate has increased over the last decade, and notable financial sector development has been observed (Athukorala and Sen 2004). Households tend to hold about half their savings in physical assets (including livestock, land holdings, and jewelry), with various forms of financial savings accounting for the other half (Figure 2.4.5). Moulick (2008) provides some qualitative evidence regarding how lack of access to the formal financial system affects saving patterns among poor people in the northeast of India, including the level of household savings and the forms in which savings are held.

Mohan (2008) notes that while gross financial savings of the household sector in India have risen in recent years, households' financial liabilities have also been increasing rapidly, albeit from a low base. He attributes both phenomena to financial development as well as the broadening of access to the financial system. Lanot and Lawrence (2005) test the proposition that greater availability of credit due to financial sector development should increase consumption expenditures in areas in which such credit is required, including durables consumption, education, and health. They find a positive association between financial development variables and expenditures on durable goods in India, but

2.4.5 Breakdown of gross domestic household savings by type of instrument, physical and financial, India, 2007



Notes: Financial savings comprise currency, net deposits, shares and debentures, net claims on government, life insurance funds, and provident and pension funds.

Source: S. Jha, E. Prasad, and A. Terada-Hagiwara. Forthcoming. "Saving in Asia: Issues for Rebalancing Growth." ADB Economics Working Paper Series. Asian Development Bank, Manila.

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the economic size of this relationship is small. Nair (2006), in contrast, finds a statistically and economically significant effect of financial liberalization on household consumption.

Mortgage availability that is restricted by the requirement of a minimum down-payment ratio has been observed in the PRC and Korea. For Korea, Park and Rhee (2005) find that increases in housing prices and in down-payment requirements can explain the rise in saving rates among households with relatively young household heads, a result that echoes the one reported by Chamon and Prasad (2008) for the PRC. In the PRC, escalating housing prices in recent years in urban areas and the higher cost of mortgages following tight monetary policy have depressed housing consumption. In this circumstance, saving will increase. If saving drives growth, such financial restrictions can move a low-growth economy from a low-saving/low-growth to a high-saving/high-growth equilibrium. This is the opposite of what the financial repression view would dictate—financial repression generates more saving, capital deepening, and growth.

To summarize, existing empirical studies of saving in developing Asia point to a range of important factors—income growth, demographic change, precautionary saving, and financial underdevelopment. There seems to be significant variation across economies regarding the dominant factor determining households' saving decisions. Two case studies—the Philippines and the PRC—will help illustrate the alternative hypotheses of saving behavior.

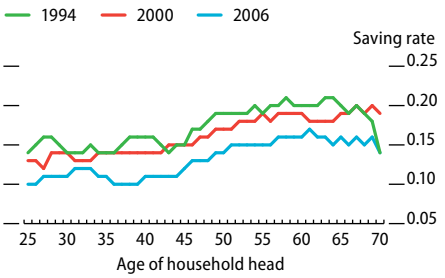
Household saving in the Philippines

The Philippines' Family Income and Expenditure Survey is conducted every 3 years. Seven survey results are available from 1988 to 2006. The survey provides household information, including details of income sources and consumption expenditures. It also provides demographic and employment information about household members, living conditions, and a number of other household characteristics. As previously discussed, the household saving rate in the Philippines (based on flow-of-funds data) has declined over time—from 9.8% of GDP in 2000 to 1.7% in 2006, rebounding somewhat to 2.4% of GDP in 2007. This declining trend and slight pickup can similarly be observed at the household level.

The age–saving profile shows an interesting pattern. The household saving rate increases nearly monotonically with the age of the household head in all available surveys (Figure 2.4.6). Yet the age–income and age–consumption profiles tend to be hump-shaped, just as in most other economies (Figure 2.4.7). Remarkably, saving rates are highest among households whose heads are past the normal retirement age. There is almost a linear relationship between the average household saving rate and age of household head beyond age 46, even after controlling for year and cohort effects. This finding holds regardless of whether the household head is male or female, or whether the income level is within the top 25th percentile, though to varying degrees. From the age range in the mid-40s to the mid-60s, there is a 3 percentage point increase in the household saving rate (from 21% to 24%).

Demographic development has been cited as one of the factors explaining the declining saving trend over time in the Philippines

2.4.6 Age–saving profile, Philippines

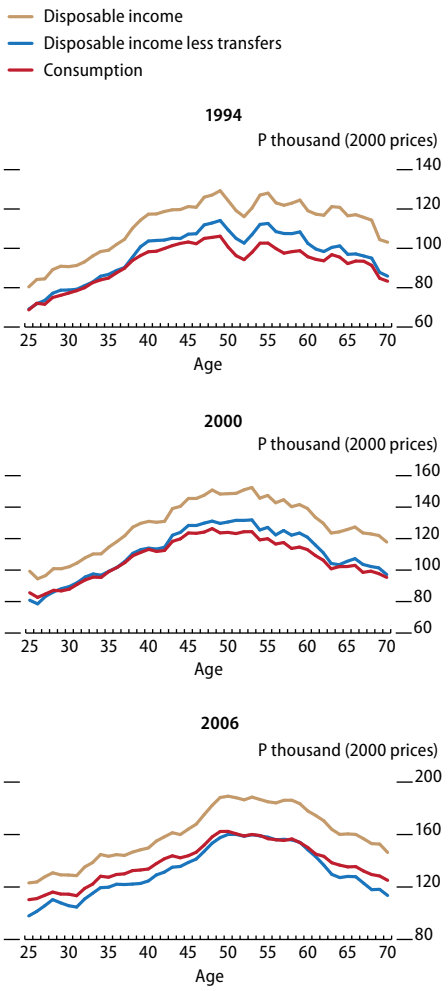


Note: Series represents 3-year moving average (the averages for each age were combined with those for the ages immediately above and below).

Source: Staff estimates based on data from family income and expenditure surveys.

Click here for figure data

2.4.7 Age–income and age–consumption profiles, Philippines



Source: Staff estimates based on data from family income and expenditure surveys.

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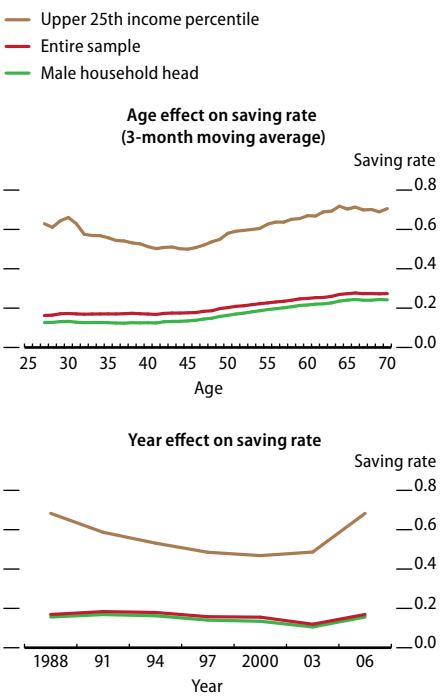
(Figure 2.4.8, bottom panel). Bersales and Mapa (2006) analyze the same survey (up to 2003) and report that the declining trend has to do with the higher proportion of young dependents in the economy. In fact, the share of dependent population (those 15 years of age or less) in 2005 was about 36% of the total population in the Philippines—close to South Asian economies' average and much higher than its neighboring Southeast Asian economies' average of about 26%. The increase in the young dependency group would have increased education and health expenditures, which would result in lower aggregate saving.

Factors responsible for the upward sloping age–saving rate profile could be financial sector underdevelopment and family composition. Bersales and Mapa (2006) argue that remittances are a major source of aggregate household saving. Figure 2.4.9 shows that the share of other income as a share of total income, roughly 40% of which is accounted for by remittances from abroad, steadily increases to over 60% by age 80 with the 2006 survey. To the extent that elderly heads are receiving the remittances from their working-age family members abroad, and that these financial flows are channeled though the informal financial sector and not directed to productive use in the economy, the saving rates of households with elderly heads would increase.

This argument is consistent with the family composition factor in linking demography to saving rates as discussed earlier. In the Philippines, households headed by retirement-age individuals also live with working-age family members, which would contribute to their higher saving rates.

2.4.8 Age and year effects, Philippines



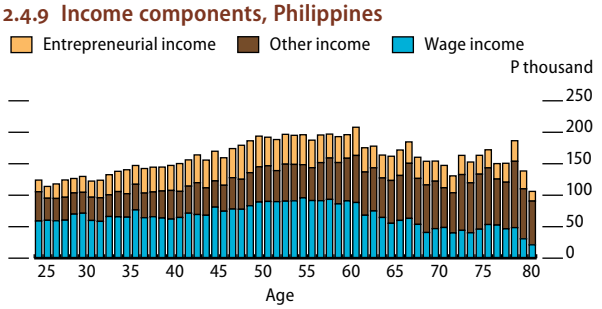
Source: Staff estimates based on data from family income and expenditure surveys.

Click here for figure data

Household saving in the People's Republic of China

For the PRC, analysis using annual urban and rural household surveys for the period 1990–2005 explains the surge in household saving in the country. As with the household surveys in the Philippines, the PRC survey also provides household information needed for detailed analysis of their saving behavior. Figure 2.4.10 shows that urban, rural, and total PRC household saving, as a ratio of disposable income, has been gradually rising since 1990, reaching nearly 26% in 2007. Household saving rates have increased in almost all income deciles, except at the lowest part of the household income distribution (Figure 2.4.11). This increase has been driven largely by the rise in the saving rate of urban households.

2.4.9 Income components, Philippines



Note: Entrepreneurial income is income derived by the family when engaging in entrepreneurial activities.

Source: Staff estimates based on data from the 2006 Family Income and Expenditure Survey.

Click here for figure data

Figure 2.4.12 plots the saving rate by age of the head of household between 1990 and 2005. In 1990, the age–saving profile exhibits a hump-shaped pattern, with the saving rate increasing with age, peaking at around age 50, and then declining with age. Such behavior is approximately what life-cycle theory would predict, given borrowing constraints that limit borrowing against future income and rising labor earnings over some range of the working life. However, the age–saving profile begins to shift to a U-shaped pattern in the mid-1990s, and this pattern becomes more pronounced in the 2000s. That is, young households save much more of their income than was the case a decade ago. Saving rates then decline with age with a trough around the 40s, before rising as the household head approaches retirement age. This

type of saving behavior—relatively high saving rates at the early and late stages of the life cycle—is puzzling as it does not conform to the standard life-cycle model, especially in the context of a fast-growing economy.

These simple age–saving plots of course mix together age, year, and cohort effects. For instance, different cohorts could have different saving propensities that affect these profiles. Figure 2.4.13 shows separately the age, cohort, and year effects on household income, consumption, and saving, with all three variables measured in per capita terms. The results in all three right panels of Figure 2.4.13 confirm that consumption tends to track income. The age effects in the panels at the top show that income and consumption initially increase with age before steadily declining.

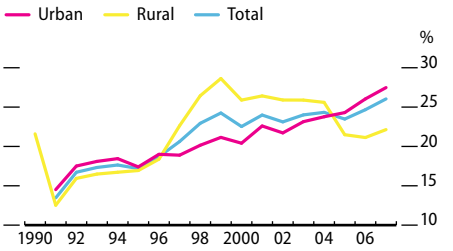
The implied effect on the saving rate is similar to the saving rate profile as a function of age observed in the cross-section for the recent years (although the amplitude of the movements is smaller). It indicates that young households save substantially, but then saving rates gradually decline (by about 10 percentage points), reaching a trough at around age 45. Saving rates increase rapidly after the age of the household head crosses the mid-40s and remain high, even among much older households. This U-shaped pattern of saving is a striking departure from the traditional hump-shaped pattern suggested by the life-cycle permanent income hypothesis.

The cohort profiles of income, consumption, and saving are shown in the panels in the middle. They suggest that younger and older cohorts had relatively higher income than those in their 20s and 30s in 1990. The resulting effect on saving suggests that the higher saving cohorts are those that were in their 40s and 50s in 1990 (saving about 7.5 percentage points more than later cohorts). This could be capturing the fact that those cohorts were particularly hard hit by the reform process and bore the brunt of the increase in uncertainty associated with the move toward a market economy. The sharp increase in the saving rate in the later working years is also consistent with postponing retirement saving until retirement is near, which is the optimal response to rapid expected income growth.

Finally, the year effects as shown in the panels at the bottom of Figure 2.4.13 point to upward trends in both income and consumption. Income grows more rapidly than consumption, resulting in a strong increasing trend in saving. Could this trend in saving be driven by the substantial demographic shifts that have taken place over the last two decades and that are likely to intensify over the next two decades? The estimated year effects explain a 9 percentage point increase in the saving rate from 1990 to 2005. This is large, particularly considering the host of life-cycle and demographic characteristics for which the authors control, and accounts for most of the increase in average saving rates over this period. This suggests a limited role for demographic changes in explaining the rise in PRC urban household saving over the last decade and a half.

Chamon and Prasad (2008) conclude that habit formation, demographics, and the life-cycle hypothesis cannot explain the rising household saving rate in the PRC in the face of rapid income growth. This is consistent with other studies, such as Horioka and Wan (2007), that use province-level data and find a limited role for variables related to the age

2.4.10 Saving rate, People's Republic of China

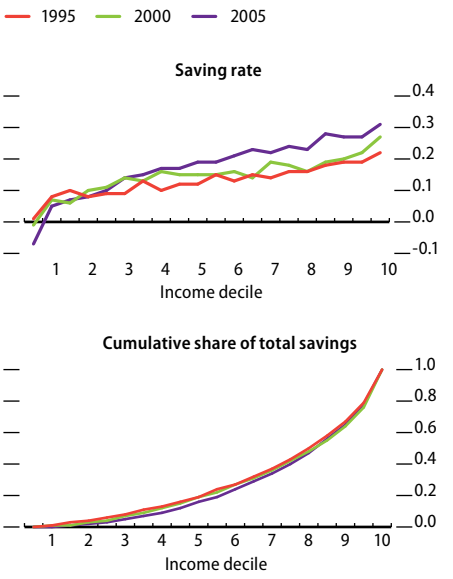


Notes: Household savings survey data are based on per capita income and consumption, and population available from CEIC. Saving rates from urban and rural household surveys are expressed as a share of disposable income and net income, respectively. Data for urban and total are missing for 1990.

Source: M. Chamon and E. Prasad. 2008. "Why Are Saving Rates of Urban Households in China Rising." NBER Working Paper 14546. National Bureau of Economic Research, Cambridge, Massachusetts.

Click here for figure data

2.4.11 Saving rate and income distribution, People's Republic of China



Source: See Figure 2.4.10.

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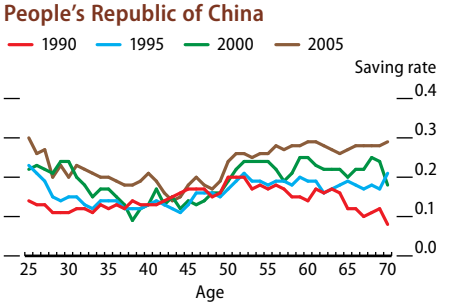
2.4.12 Age-saving profile, People's Republic of China



Source: See Figure 2.4.10.

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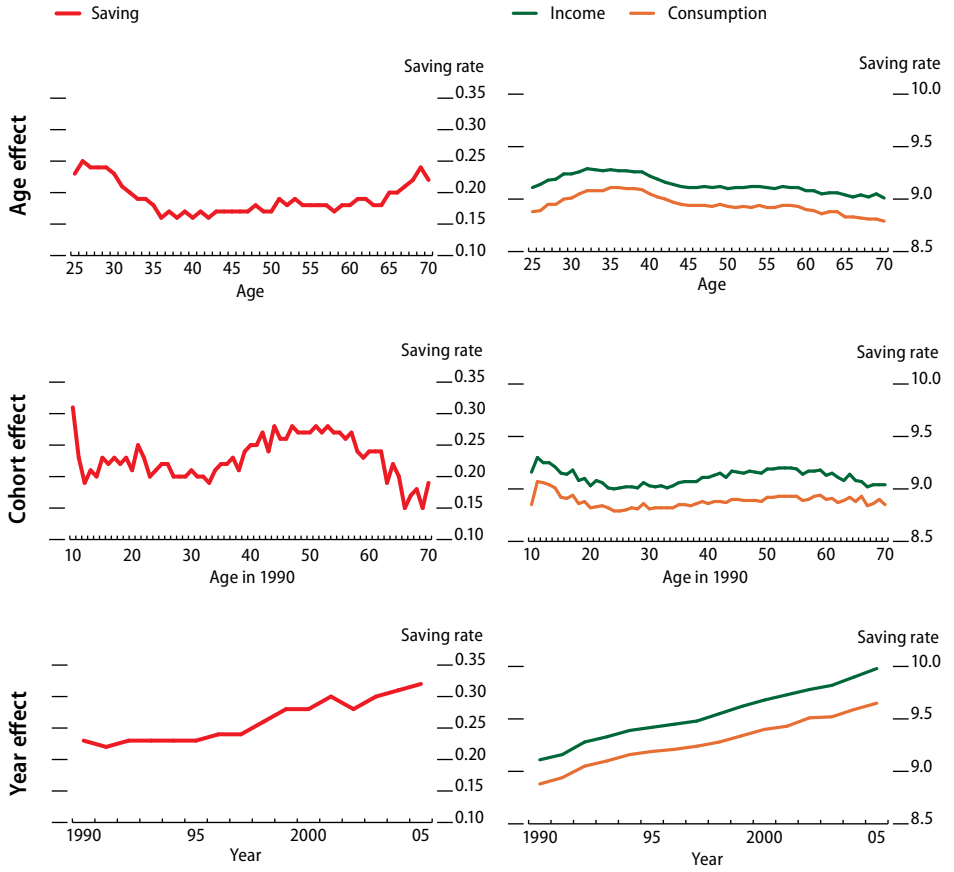
2.4.13 Age, cohort, and year effects, People's Republic of China



Notes: Effects are based on a regression of average log(Y) and log(C) on a vector of age, cohort dummies, and time dummies. Cohort dummies are constrained to add to zero and to be orthogonal to a linear trend. Log(Household Size),and share of household members aged 0–4, 5–9, 10–14, 15–19, and 20+ are used as controls. The reference household is one that was 25 years old in 1990. Each profile displayed holds the other two effects constant at their respective levels for the baseline household. For example, the age profile shows how income, consumption, and saving vary with age, holding the cohort effect constant at its level for households aged 25 in 1990, and the year effect constant at its 1990 level.

Source: See Figure 2.4.10.

Click here for figure data

structure in explaining saving behavior. Instead, the increasing private burden of education and health expenditures seem among the strongest candidates for explaining the increase in saving rates, at least during a transition period.

Feng et al. (2009) also arrive at a similar conclusion in their analysis of urban households in the PRC. In the process of restructuring the economy toward a market-oriented system, traditionally high social transfers were reversed. Education and health lost government support and became private and expensive. The total budget allocation for health and education combined stood at around 18% of total government expenditure in 2007 (Figure 2.4.14), well behind peer countries' standards. Health expenditure-related risks can largely explain the dramatic increase in saving rates among elderly households. The uncertainty related to those expenditures can also increase aggregate saving rates, despite the higher consumption expenditures of households suffering an adverse health shock.

The effects of these shifts, together with precautionary motives stemming from state enterprise restructuring and market-oriented reforms, should eventually fade as households adjust their consumption plans and build up a level of assets appropriate to this post-transition environment. This buildup in savings might have been smaller if financial markets had been more developed. Financial frictions also strengthen precautionary saving motives, and borrowing constraints can play an important role in driving up saving rates despite rapid income growth, especially among younger households.

Concluding comments

Countries in Asia that have achieved high growth rates are also characterized by high saving rates. While the share of corporate saving has increased markedly in recent years, household saving remains an important source of national saving in many countries. The sharp increase in corporate saving and the evolution of PRC saving both play large roles in influencing overall saving patterns in Asia.

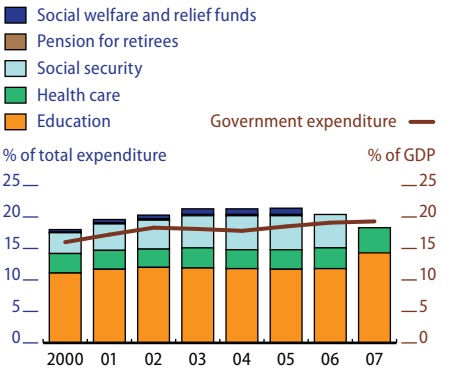
Corporate saving largely reflects the retained earnings of firms. Data on corporate saving for the PRC show a rapid rise in the profitability of state-owned and private enterprises. The large cash holdings and internal investment of these enterprises can be attributed to several interrelated factors. These include firm-specific factors (such as firm-level uncertainty and underfunding of company pensions), macroeconomic factors (including robust growth, low real interest rates, falling labor costs, and growing output prices), and policy-induced factors (such as state subsidies for land and energy, low dividend-payout ratios, a repressed financial system, and lack of alternative financing mechanisms). Moreover, payouts from large and profitable firms go disproportionately to the rich, who have higher saving propensities than the poor, which contributes to the saving spiral.

Corporate saving in India—which is among the lowest in the world—is taking root. Currently, it contributes barely 25% of national saving in contrast to 60% in the PRC. Corporate saving growth in India has been aided by sustained reductions in the corporate tax rate, the peak rate of customs duty, and nominal interest rates. Financial restructuring of firms reduced their debt, while new technology helped improve productivity and efficiency.

As the effects of the global slowdown permeate the Asian region and reduce corporate profitability, household saving could regain its dominance. Even though the share of household saving in national saving has declined, household saving has continued to rise as a share of disposable income in many developing Asian economies. In particular, the rising household saving rate in the PRC has played a key role in explaining the rising current account surplus in the region. The surge in household saving in the PRC has been driven largely by the rise in the saving rate of urban households. The increasing private burden of education and health expenditures seems among the strongest candidates for explaining the increase in saving rates, at least during the transition period.

Precautionary saving has been important in explaining household saving behavior in the PRC and Taipei,China. Provision of social

2.4.14 Government expenditure, People's Republic of China



Note: Government expenditure on social security is absent for 2007, government expenditure on pension for retirees and social welfare and relief funds are absent for 2006 and 2007.

Source: S. Jha, E. Prasad, and A. Terada-Hagiwara. Forthcoming. "Saving in Asia: Issues for Rebalancing Growth." ADB Economics Working Paper Series. Asian Development Bank, Manila.

Click here for figure data

health insurance has been seen to substantially weaken this motive for saving. Evidence from India shows that health care financing in Asia is dominated by private expenditures while public health systems remain weak and health insurance almost nonexistent (Peters et al. 2002; Bonu et al. 2007). The availability of health insurance is particularly important for the elderly, who face rising health care costs. Besides, health care is a normal good and the demand for it is likely to rise as per capita income levels rise in developing Asia. Hence, the provision of comprehensive social health care can play an important role in influencing household saving behavior. Improvements in social safety nets in general would pool the risks associated with idiosyncratic income shocks and health expenditures, reducing the need for households to save in order to self-insure against these risks.

Increasing public provision of education could also lower household saving by reducing the need to accumulate assets to finance future education expenditures. Hence policies that rationalize public spending to increase social transfers, reform pension systems, and provide universal health care insurance and education are top priorities. These policies will not only generate short-term demand for education and health services, but also ensure long-term human capital investment, promote lifetime earnings, and create greater economic potential.

Higher spending on social safety nets would boost domestic demand by freeing household resources. The effect would be stronger if spenders, including the poorest people, are influenced more than savers. Policies to shore up domestic demand should therefore include the poor through targeted transfers. When directed to the poor, such funds will not be saved, but used to buy goods and services, supporting the broader economy through a multiplier effect. An expansion of social services will increase government consumption as well, but attention also needs to be paid to improving the efficiency of public spending.

The buildup in savings in Asia might have been smaller if financial markets had been more developed. Financial frictions strengthen precautionary saving motives, and borrowing constraints can play an important role in driving up saving rates despite rapid income growth, especially among younger households. Financial sector development can reduce the need for saving by providing access to borrowed funds and investment opportunities, reducing rate-of-return risks, and easing liquidity constraints through systematic development of consumer credit and mortgage markets.

An efficient financial system can also promote conversion of financial resources into real investment and enhance economic growth by pooling risk, lowering the cost of borrowing, raising returns on savings, allocating savings to projects with a high marginal product of capital, and inducing investors to invest in riskier but higher-return projects. At the same time, high costs incurred by inefficient financial systems due to large spreads between deposit and lending rates, and commissions and transaction fees may eat into private consumption and reduce the efficiency of investment, thereby depressing the growth rate. This caveat should be noted in any discussion on the role of financial-sector policy in driving saving toward investment.

In general, increased availability of social security and enhanced

credit availability can reduce household saving. Policies that foster increased social expenditures and accessibility of borrowed funds could play an important role in helping to smooth consumption over the life cycle. This would moderate household saving rates and help rebalance growth toward consumption. Channeling corporate saving into investment will require financial sector development including availability of better saving instruments and an improved business and investment climate.

To sum up, policies that can shift household saving toward consumption and channel corporate saving into productive investment will help reduce the existing saving–investment gap in Asia, and thereby lead to a reduction in global imbalances.

Rebalancing growth: Trade

The previous sections explored the recent persistent current account surpluses in Asian developing countries from the perspective of their relationship to the excess of saving over investment. This part of *ADO 2009* now turns to a more direct assessment of the underlying causes of developing Asia's current account surpluses by considering the largest component of the current account: the trade balance.

Developing Asia's persistent current account surpluses reflect the fact that the dollar value of its exports of goods and services exceeds that of its imports. The ongoing contraction of global trade and unwinding of large current account imbalances—particularly in the US—will cause developing Asia's trade to rebalance. The structure and direction of developing Asia's trade and its real exchange rates will influence the manner in which the current account imbalances adjust and the longer-term effects on the region.

Structure and direction of developing Asia's trade

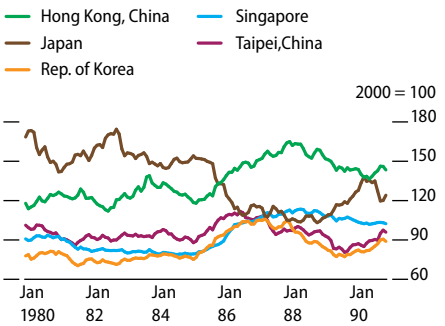
Structure of exports and imports

The emergence of Asia as the third hub of world trade—after Europe and North America—has followed a distinctive pattern over the past four decades. Following Japan's export success in the 1950s and 1960s, the NIEs of Hong Kong, China; Korea; Singapore; and Taipei,China began to enter export markets as Japan's industrial structure shifted away from labor-intensive goods to more sophisticated products.

The 1985 Plaza Accord, which saw a sharp revaluation of the yen (Figure 2.5.1), also enabled the NIEs to expand their exports of labor-intensive products, an area in which Japan was losing comparative advantage. However, by the late 1980s, these economies were losing their edge in labor-intensive activities as a result of rising labor costs and attendant real currency appreciation. In addition, the imposition and gradual tightening of quantitative restrictions by industrial countries blunted the NIEs' export penetration in the textile, clothing, and footwear markets (Wells 1986).

As profitability fell at home, producers from Japan and the NIEs began to move their production platforms to Southeast Asia. These countries attracted investors because of their relatively favorable macroeconomic conditions, and their trade and investment policies. On the heels of direct inward investment, an export boom followed in labor-intensive manufacturing. At the same time, rapid advances in production technology created an opportunity for investors to redesign production processes in ways that accentuated task specialization, that is, splitting up fabrication and assembly processes and reducing production costs (Krugman 1995). This process occurred extensively in the electronics

2.5.1 Real exchange rates



Note: An increase in the indexes shown reflects real depreciation.

Source: Bank for International Settlements database, available: http://www.bis.org. downloaded 12 March 2009.

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industry so that by the mid-1980s, Southeast Asian countries started exporting electronics and other more technologically sophisticated products. Later, in the early 1990s, the PRC emerged as a fast-growing exporter of labor-intensive manufactures. Product lines "migrated" to the PRC from elsewhere in East and Southeast Asia, attracted by its large pool of cheap labor, its rapidly improving infrastructure, and policies favoring exporters.

The evolution of trade patterns show that rapid export growth in developing Asia has been underpinned by export structures that have increasingly shifted away from primary commodities and toward manufactures. Given the nature of their resource endowments, the NIEs relied heavily on manufacturing for export expansion from the very beginning. Yet beginning in the 1970s, a notable shift toward manufactured exports is observable across all countries, albeit at varying speeds and intensities.

Since the early 1990s, the share of manufactured exports to total exports in Southeast Asian countries (other than for Indonesia and Philippines) has exceeded 70%. In the Philippines, the share of manufactured exports to total exports increased significantly after 1996, to more than 90% in 1996–2006 from 50% in 1991–1995. In Indonesia and Viet Nam (and other very small later-comer economies such as the Lao People's Democratic Republic and Myanmar) the share of manufactures in total exports is significantly lower at about 50%. This reflects both their country-specific patterns of comparative advantage and their later adoption of export-oriented industrialization strategies.

Within manufactured exports, machinery and transport equipment has become the key component in developing Asia. The share of these exports in the region's total manufacturing exports rose from about 36% in 1992 to 55% in 2006. Machinery and transport equipment exports have increased significantly in East and Southeast Asia, accounting for more than half of manufactured exports in 2006. For the Philippines and Malaysia, the share of this component in manufactured exports was about 80% in 2006, while it was around 70% in Korea and Singapore. (Indonesia and Viet Nam, for which machinery and transport equipment accounted only for 38% and 18% of total manufacturing exports in 2006 respectively, were exceptions.) While increasing in South Asia as well, machinery and transport equipment accounted for only 12% of manufactured exports in 2006. Within the machinery and transport goods component of manufactured exports, the share of information and communications technology (ICT) products exceeded 70% by 2006 in developing Asia.

Exports of machinery and transport equipment have dwarfed exports of the labor-intensive goods that were such an important component of developing Asia's manufactured exports during the mid-1980s. Since 1992, the share of textiles, clothing, and footwear in developing Asia's total manufactured exports fell by more than half, from 25% in 1992 to 11% in 2006. This shift in the export product mix is found in nearly all Asian countries except Bangladesh and Pakistan, where these items accounted for 93% and 84% of manufactured exports, respectively, in 2006. While in India, Sri Lanka, and Viet Nam, the share of labor-intensive manufactures is declining, these items still account for a relatively high proportion of total manufactured exports.

The share of developing Asia in world exports of ICT products increased from 25% in 1992 to 50% in 2006. The PRC alone accounted for 24% of total world ICT exports in 2006—up from 3% in 1992—followed by Korea and Malaysia, which each accounted for 6–7%. Electrical goods—another major component of manufactured exports—from the PRC recorded an impressive increase to 36% of world trade in 2006 from 16% in 1992. The share of the PRC in world exports of electrical goods also jumped sharply during the same period from 4% to 21%, while the shares of Korea and Taipei,China remained relatively stable at 4%.

The trend described above reinforces the view that international trade is facilitating industrialization and structural change in the region. The manner in which the composition of exports from developing Asia has evolved closely mirrors that observed previously in Japan, which successively moved into higher skill, technology-intensive manufactured exports.

The shift in developing Asia's export product mix described above notwithstanding, developing Asia still dominates total world exports of labor-intensive goods. For example, the share of developing Asia in total world clothing and footwear exports increased to almost 52% in 2006 from 41% in 1992. The PRC accounted for much of this increase, but in contrast to ICT exports, the geographic dispersion of Asian developing countries exporting labor-intensive products has been broader. A number of low-income countries in Southeast and South Asia, including Bangladesh, India, Indonesia, Sri Lanka, and Viet Nam, have all recorded impressive gains in their respective world market shares in total labor-intensive exports.

The composition of developing Asia's imports has always been heavily biased toward manufactured goods—more than 75% of total imports in 1992–2006. Within manufactured imports, machinery and transport equipment account for the largest share, the latter rising from 52% in 1992 to 61% in 2006. The share of imports of ICT products in total manufactured imports has risen sharply in all Southeast and East Asian economies (especially Hong Kong, China; Malaysia; Philippines; and Singapore) where these goods made up 50% of total machinery and transport equipment imports. Imports of electronic goods have also risen to the degree that the share of ICT and electrical products taken together now exceeds the share of nonelectrical machinery in the total manufactured import basket of most developing Asian economies.

Trade in parts and components

The ongoing process of global production sharing—in which Asian developing economies are increasingly integrated into international production networks—lies behind Asia's rapid growth in the trade of manufactured products such as machinery and transport equipment. The share of parts and components in developing Asia's total manufacturing trade has increased continuously since the early 1990s—on the export side the share increased from 16% in 1992 to 25% in 2006. Trade in these goods is concentrated in ICT products and electrical machinery.

Countries in East and Southeast Asia stand out within the region for their heavy dependence on parts and components for their export dynamism. In 2006, manufacturing export shares were 40% in East

Asia and 26% in Southeast Asia. In the Philippines, the share of parts and components in total manufactured exports doubled to almost 70% in 2006 from 1992. Also, in the PRC, parts and components accounted for 19% of total manufactured exports in 2006, rising from 4% in 1992. Even in Korea and Taipei,China, shares of components in manufactured exports are rising, contradicting the popular belief that these economies had already shifted palpably from assembly activities to final goods production. In contrast, South Asia's parts and components exports are limited. Although India has great potential to benefit from this new form of international specialization—given its low labor costs, trainable work force, and favorable location—parts and components constituted only 7% of its manufactured exports in 2006.

Parts and components account for a growing share of developing Asia's total import basket as well, rising from 22% in 1992 to 36% in 2006. That these goods are important for both imports and exports highlights the East and Southeast Asian economies' place in the international production chain. In comparing the percentage share of parts and components in total exports and total imports, an important difference between the PRC and other developing Asian countries emerges: in the PRC, parts and components account for a much larger share of imports than exports. In other Asian developing countries, the reverse holds true. This difference suggests that the PRC is playing an increasingly important role in final product assembly using parts and components procured from other countries in the region.

The increasing importance of the parts and components trade results in a rise in intra-industry trade. Intra-industry trade can be measured by the Grubel-Lloyd index (Box 2.5.1). Higher values indicate a greater reliance on intra-industry trade for the economy in question. Figure 2.5.2 shows that intra-industry trade has risen significantly in developing Asia, from less than 0.35 in 1992 to more than 0.50 in 2006. Trade in parts and components has contributed notably to this increase. Although intra-industry trade was more pronounced in East Asia, it increased sharply

2.5.1 Measuring intra-industry trade

Intra-industry trade is the value of exports of goods from an industry that are matched by the value of imports of goods to the same industry. The Grubel-Lloyd index is a common measure of intra-industry trade (Grubel and Lloyd 1975).

For a given industry i in an economy, let X_i denote the value of exports and M_i the value of imports at some point in time. The value of intra-industry trade (I_i) is then as

$$I_i = (X_i + M_i) - |X_i - M_i| \quad (1)$$

The value of intra-industry trade in equation (1) is then normalized by total trade ($X_i + M_i$) to give

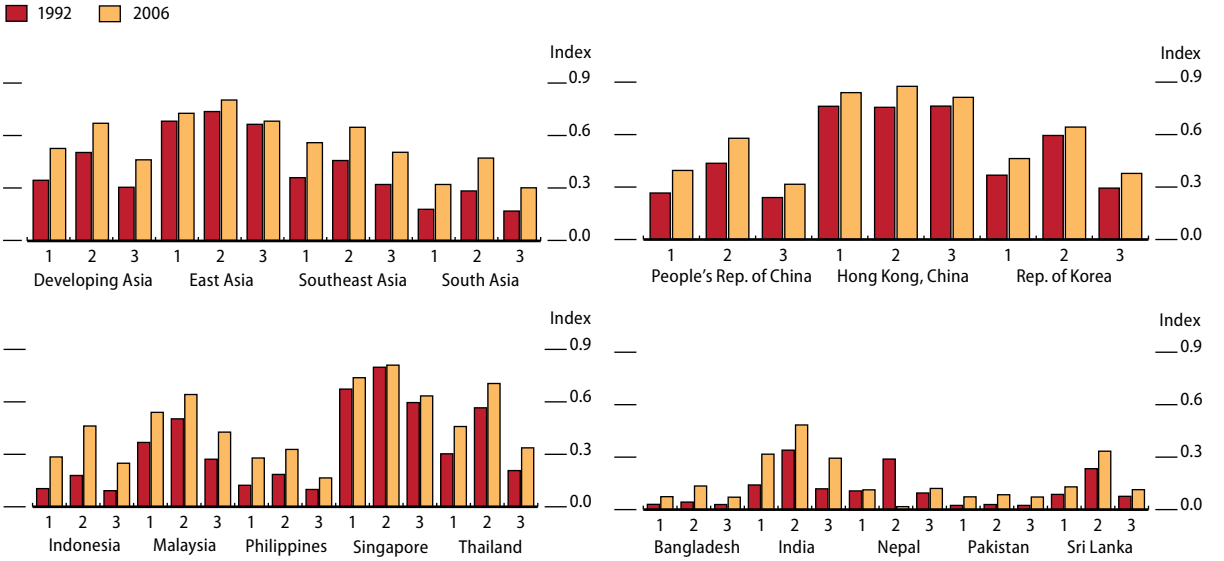
$$IIT = \left(1 - \frac{|X_i - M_i|}{(X_i + M_i)}\right) \quad (2)$$

The index ranges between zero and one. An index value of one means that the economy simultaneously imports and exports the same value of products from that industry, which is a case of pure intra-industry trade. By contrast, an index value of zero means that the economy only imports or exports goods from that industry, which implies pure inter-industry trade.

Reference

H.G. Grubel and P.J. Lloyd. 1975. *Intra-Industry Trade: The Theory and Measurement of International Trade in Differentiated Products*. London: Macmillan.

2.5.2 Intra-industry trade index



1 = total; 2 = parts and components; 3 = finished goods

Note: The end periods for Bangladesh, Nepal and Sri Lanka are 2004, 2003, and 2005, respectively.

Source: Staff estimates. *Click here for figure data*

in Southeast Asia, particularly in Indonesia, Malaysia, and Thailand. In Singapore, the high level of intra-industry trade—which reached 0.74 in 2006—was driven by trade in parts and components.

Within East Asia, the most notable rise in intra-industry trade occurred in the PRC, where the overall index increased by 13 percentage points. As in Southeast Asia, the rise in total intra-industry trade in the PRC is due to the rising importance of trade in parts and components. Intra-industry trade is less significant in South Asia, although the index does show an increasing trend. The significant increase of intra-industry trade in parts and components confirms the previous finding of the growing importance of vertically integrated regional trade involving technology-intensive and human capital-intensive manufacturers (ADB 2007). In contrast, the importance of intra-industry trade generally falls in unskilled labor-intensive manufactures.

Direction of trade

Direction-of-trade data show that Asia has become increasingly integrated. The share of manufacturing trade within developing Asia increased to 48% on average in 2005–2006, up from an average of 40% in 1994–1995. Intraregional trade was far higher than extraregional trade with the countries of the North American Free Trade Agreement (NAFTA), EU15, and Japan, where in 2005–2006 the share of Asian manufacturing exports in these three markets was 18%, 16%, and 13%, respectively. The increasing importance of intraregional trade was mainly due to increases in intraregional trade in the countries of East and Southeast Asia. In Southeast Asia, the share of intraregional trade in total manufacturing trade rose to 52% in 2005–2006 from 40% in 1994–1995, with the corresponding figures for East Asia 48% and 42%. There is, however, a notable difference between export and import trade: across all developing Asia's subregions, import trade is more highly integrated than export trade.

Disaggregating manufacturing trade into final products on the one hand and parts and components on the other shows why this is the case: intraregional trade in Asia is mainly concentrated in parts and components. The intraregional share of developing Asia's parts and component trade rose by almost 20 percentage points over the past decade, reaching 62% in 2005–2006, as compared to an 8 percentage point increase in total trade in manufacturing over the same period. In contrast, an increase in intraregional trade in the PRC came only from the import side, while for the other developing Asian economies, exports also contributed to the increase in intraregional trade.

While the share of the PRC's intraregional exports of parts and components has been relatively stable over the past decade, intraregional imports of parts and components rose to 73% in 2005–2006 from only 56% in 1994–1995. For other developing Asian economies, the PRC has become a key export destination for their parts and components. For example, on average, in other East Asian countries, the share of intraregional exports amounted to 20% in 2005–2006, up from only 4% in 1994–1995. In Southeast Asia, however, it rose to 17% from 1% during the same period. These differences in the geographic pattern of imports and exports reflect the increasingly important role played by the PRC as a final product assembler.

Manufactured exports from the PRC to developing Asia dropped notably as a share of total manufactured exports during 1994–2006, with North America and the EU becoming increasingly more important export markets. The geographic patterns of manufacturing and parts and components trade confirm that the rise of the PRC as a final assembler has contributed to the growing importance of nonregional demand, especially for final products. The lower level of intraregional integration on the export side mentioned earlier also reflects the dependence of Asia on nonregional markets for its export-led growth.

For exports of labor-intensive products such as textiles and clothing, developing Asia has become even more dependent on North American and EU markets, which accounted for 42% of the region's textile and clothing exports in 2005–2006, up from 35% in 1994–1995. The PRC was the main source of this increase in market share. In Southeast Asia, more than 70% of total textile and clothing products were exported to NAFTA and the EU15 in 2005–2006,[14] up from 65% in 1994–1995. Consequently, any shock from industrial countries' export demand could hit developing Asia's export performance hard, for both technology- and labor-intensive products.

Sources of change in developing Asia's trade patterns

The role of structural factors

Three mutually reinforcing developments underpin the structural shift in trade patterns toward machinery and transport equipment—particularly trade in parts and components—over the past few decades. First, rapid advancement in production technology has allowed companies to

"unbundle" stages of production into finer, portable components so that different tasks can be performed in different places. Second, technological innovations in transportation and communications have improved the speed, efficiency, and economy of coordinating geographically dispersed production processes. This has facilitated establishment of "service links" to combine various fragments of the production process in a timely and cost-efficient manner (Jones and Kierzkowski 2001). Third, liberalization policy reforms in both home and host countries have considerably lowered barriers to trade and investment (Athukorala 2006). Tariff and nontariff barriers in manufacturing have declined continuously over the past few decades, resulting in a reduction in costs of production, thus spurring manufacturing trade.

While trade expansion helps attract foreign direct investment (FDI), reforms of investment policies and regulatory regimes have also contributed to a surge in multinational enterprises (MNEs) establishing a presence in developing Asia (Brooks et al. 2004). Most countries offer incentives for attracting FDI, especially efficiency-seeking FDI that helps promote exports, such as establishing export processing zones or free trade zones; and providing tax concessions, tax credits, accelerated depreciation allowances for plant and machinery, export subsidies, and import entitlements.

Yet such incentives may only marginally influence investment location decisions. The overall investment climate in a country is more important to most potential investors than narrowly defined investment incentives. Among the most important factors in this regard is the size and expected growth rate of the market to be served, the long-term macroeconomic and political stability of the host country, the supply of skilled or trainable workers, and the presence of modern transportation and communication infrastructure.

These investment climate factors helped East and Southeast Asia become preeminent locations for global production sharing. As pioneers in this area of international specialization, economies in those subregions offer considerable agglomeration advantages for companies already located there (Athukorala and Kohpaiboon 2008). Site selection decisions of MNEs operating assembly activities are strongly influenced by the presence of other key market players in a country or its neighbors. Against the backdrop of a long period of successful operation in the region, many MNEs—particularly US-based MNEs—have significantly upgraded the technical activities of production networks in the region and have assigned global production responsibilities to affiliates located in these subregions. That is, MNE affiliates tend to become increasingly embedded in host countries the longer they are there, which helps further improve the host country's investment environment.

Liberalization of the trade and investment policy regime—which attracted efficiency-seeking FDI in the first place—has contributed to the change in the trade structure toward machinery and transport equipment and parts and components trade. Such liberalization may have played a role in creating successive trade and current account surpluses in developing Asia, especially the PRC. Production cost reductions from such liberalization improve a country's competitiveness.

In addition, despite rapid growth, manufacturing wages in countries

in these regions still remain lower than or comparable to those in the Eastern European and Latin American countries. Significant differences in wages among the countries within these regions have provided the basis for rapid expansion of an intraregional production sharing system, giving rise to increased cross-border trade in parts and components. The emergence of the PRC as the prime low-cost assembly center for a wide range of electrical and electronic products has boosted component production and assembly activities in other Asian countries.

However, there are concerns that some incentives provided by governments could result in distortions in favoring export markets over the domestic market or manufacturing over the services sector, or both. In fact, the objective of, for example, export processing zones is to promote manufacturing exports through MNEs' investment in order to directly provide jobs and alleviate unemployment, and obtain foreign exchange earnings. In addition, such zones are aimed at providing indirect effects in terms of knowledge spillovers that can take place in many ways,[15] and backward linkages when companies begin to buy more inputs from host countries.

Both direct and indirect effects could further generate domestic consumption and investment in host countries. Nevertheless, some empirical studies (e.g. Furby 2005; Rondinelli 2006) show limited positive impacts from these zones since the zones primarily employ low-wage, unskilled workers, create employment that can only be maintained if demand for exports holds up, transfer little modern technology or know-how, and have weak links to domestic manufacturers. In addition, governments in many countries deliberately provide preferential tax treatment and other incentives to export-oriented manufacturers, limiting knowledge spillovers and backward linkages. Thus benefits to host countries, especially in promoting domestic consumption and investment, are limited.

The role of the real exchange rate

Movements of the real exchange rate[16] have generally played a minor role in influencing the structural shift of trade toward machinery and transport equipment, especially when the trade is mainly in parts and components (Jones and Kierzkowski 2001; Arndt and Huemer 2004; Athukorala 2004; Jongwanich forthcoming). Exports generated as part of a global production chain frequently have high import content. So although currency depreciation lowers the export price, it simultaneously raises the input cost (Box 2.5.2). To the extent that import content costs rise, this will offset any expansion in demand induced by depreciation.

Further, international product fragmentation requires service links to be set up in order to connect the various fragments of a production process in a seamless, rapid, and cost-efficient manner. MNEs assembling products along an international production network are strongly influenced by infrastructure, logistical capabilities, the availability of skilled workers, and modern technical and managerial skills when deciding where to locate facilities. In these circumstances, real exchange rate changes are but one part of a far wider set of considerations about where to locate production facilities.

However, the real exchange rate by itself could still influence a

2.5.2 Exports and real exchange rate in East and Southeast Asia

This box shows the relationship between the real exchange rate (RER) and real exports in eight East and Southeast Asian economies, namely People's Republic of China (PRC); Indonesia; Korea; Malaysia; Philippines; Singapore; Taipei,China; and Thailand. To emphasize the increasing importance of the parts and components trade, export equations are estimated for three different export categories—total merchandise exports, manufactured exports, and exports of machinery and transport equipment. The analysis is based on quarterly data during 1993–2008, a period over which the parts and components trade burgeoned.

To examine the role of the RER, reduced-form equations (derived from both demand for and supply of exports) are estimated for total merchandise exports, total manufactured exports, and exports of machinery and transport equipment. According to this reduced form, real exports are set as a function of the real exchange rate, world demand, production capacity, and foreign direct investment. Under the different order of integration, the cointegration econometric procedures such as the two-step residual-based procedure adopted by Engle-Granger (1987), and the system-based reduced rank regression approach due to Johansen (1988) for modeling nonstationary data are inappropriate. The econometric analysis in this study is based on the General to Specific Modeling procedure (Wickens and Breusch 1988; Hendry 1995).

In general, the long-run real exchange rate coefficients for machinery and transport equipment exports are the lowest (or insignificant) while the coefficients for total merchandise exports are the highest, with those of manufacturing exports at intermediate levels. These results indicate that exports of manufactured final products, especially labor-intensive products, are more responsive to changes in the RER than are exports of machinery and equipment, which must rely to a greater extent on imported parts and components. RER coefficients vary across the eight economies.

In general, the RER has the least impact on the Philippines' exports, while the impact is the greatest in Indonesia. In the Philippines, the long-run coefficients for the RER in all three categories are statistically insignificant, while in the short run, the coefficients are equal to 0.2 for total merchandise exports. In the case of Indonesia, by contrast, they are greater than one for total merchandise and manufactured exports (both in the short and long run), and less than one for machinery and transport equipment exports, that is, 0.72 in the short run and 0.97 in the long run. This is consistent with the fact that the Philippines' exports and imports have been dominated by parts and components over the past decade. In contrast, Indonesia's export basket exhibits a much greater degree of product diversification.

The coefficient for manufacturing export volume with respect to changes in the RER in Korea; Singapore; and Taipei,China are all relatively low in both the short and long run. In the long run, the RER coefficient corresponding to machinery and transport equipment in these economies is not significantly different from zero. In the short run, it is statistically insignificant in the case of Korea and Taipei,China, while it is about 0.5 in Singapore. In addition to the high degree to which parts and components are represented in the export basket, RER coefficients are also influenced by technological sophistication and the degree of complexity of exports. More advanced and sophisticated products may offer fewer opportunities for substitution, which results in a lower level of response for exports to changes in the RER. In Malaysia and Thailand, the long-run RER coefficients for total exports are comparatively high. This may reflect a more diversified export structure.

Note: Details of export equations are available in J. Jongwanich. Forthcoming. "Determinants of Export Performance in East and Southeast Asia." *World Economy*.

The RER coefficients in eight East and Southeast Asian economies

	Short-run coefficient			Long-run coefficient		
	Total merchandise	Manufacturing	Machinery and transport equipment	Total merchandise	Manufacturing	Machinery and transport equipment
China, People's Rep. of	0.60*	0.69*	0.61*	0.50**	0.50**	-
Indonesia	1.17*	1.44**	0.72*	4.52*	2.15*	0.97*
Korea, Rep. of	1.12*	-	-	1.17*	0.14***	-
Malaysia	0.64*	0.65*	0.48*	1.48*	1.37*	1.06*
Philippines	0.20**	-	-	-	-	-
Singapore	-	0.89(-2)***	0.53 (-2)**	-	-	-
Taipei,China	0.38 (-3)**	0.33 (-3)***	-	-	-	-
Thailand	0.34*	0.18*	0.14*	0.70*	0.39***	-

- = statistically insignificant.

Note: The values in parentheses show the lag period of the significance. * Significant at the 5% level; ** significant at the 10% level; and *** significant at the 15% level.

2.5.3 The equilibrium real exchange rate

The real exchange rate (*RER*) is a broad summary measure of the prices of one country relative to the prices of another country or group of countries, both expressed in a common currency.

$$RER = \prod_{i=1}^{I} \frac{(e_i P^*_{i,f})^{W_i}}{P_D} \qquad (1)$$

where e is the nominal exchange rate defined as the number of units of home currency to each unit of foreign currency, P^* denotes the foreign (world market) price level, and P is the domestic price level, w is the trade weight. Both domestic and foreign prices are measured by the consumer price index (CPI).

The equilibrium real exchange rate is defined here as the relative prices that, for given sustainable (equilibrium) values of other relevant variables, result in the simultaneous attainment of *internal* and *external* equilibria (Edwards 1989; Hinkle and Montiel 1999; Baffes et al. 1999). *Internal* balance is defined as a situation in which the demand for and supply of nontradable goods are equal. *External* balance is characterized as a sustainable balance-of-payments position over the medium term, ensuring desired net flows of resources and external debt sustainability. Based on this concept, the equilibrium real exchange rate (*RER**) is defined as follows:

$$RER^* = f(PRO, TOT, NFA, GS, OPEN) \qquad (2)$$
$$\qquad\qquad\quad - \quad - \quad - \quad - \quad +$$

where *NFA* is net foreign assets, *GS* is government spending, *PRO* is the difference in the rate of productivity growth in tradable-good production of a country compared to that of the main trading partner countries, *TOT* is the terms of trade and *OPEN* is the degree of trade policy openness.

An increase in productivity growth in tradable production (*PRO*) will raise the demand for labor employed in the tradable sector. Under conditions of full employment, labor must be drawn from the nontradable sector toward the tradable sector. This puts upward pressure on the wage rate in the nontradable sector. This causes the *RER** to appreciate to restore both internal and external balance. Thus, the *RER** will have a negative relationship with *PRO*. This is known as Harrod-Balassa-Samuelson effect (Obstfeld and Rogoff 1996).

The terms of trade (*TOT*), the ratio of export to import prices, is included to capture exogenous changes in world prices that affect the *RER**. An exogenous increase in export prices relative to import prices improves the country's terms of trade. *TOT* improvement generates an income effect, which increases domestic demand. To restore internal and external equilibria, nontradable prices must increase relative to tradable prices (*RER** appreciation) in order to switch demand from nontradable toward tradable goods.

This effect could, however, be counterbalanced by a substitution effect in which demand for tradable goods increases from relatively lower import prices, and leads to overall real depreciation. Thus, in theory, the relationship between the *RER** and *TOT* is ambiguous. However a sizable empirical literature has found that in developing countries, an improvement in *TOT* tends to cause appreciation in *RER** because the income effect generally tends to overwhelm the substitution effect (Edwards 1989; Elbadawi 1994; Baffes et al. 1999).

An increase in NFA tends to improve a country's wealth. Nontradable prices increase in response to a rise in domestic demand. The equilibrium real exchange rate appreciates. In addition, larger real interest rate differentials lead to an increase in capital flows and real exchange rate appreciation. While government expenditure (*GS*) is mostly spent on nontrabable goods, nontradable prices increase in response to a rise in domestic demand.

Thus, a negative relationship (appreciation) between government expenditure and the equilibrium real exchange rate is expected. Trade openness (*OPEN*) is included since a shift in a country's trade policy toward greater liberalization leads to an increase in demand for tradable goods. The *RER** is required to depreciate in order to switch demand from tradable goods toward nontradable goods, thus restoring equilibrium. *RER** is thus positively related to the degree of trade liberalization.

To estimate equation (2), the econometric method proposed by Johansen (1988) is applied since all variables under consideration are nonstationary series. This method is based on a Full Information Maximum Likelihood (FIML) algorithm and therefore has the potential to address problems of simultaneity. Note that since the equilibrium rate (*RER**) is unobservable, there are two steps in estimating *RER**.

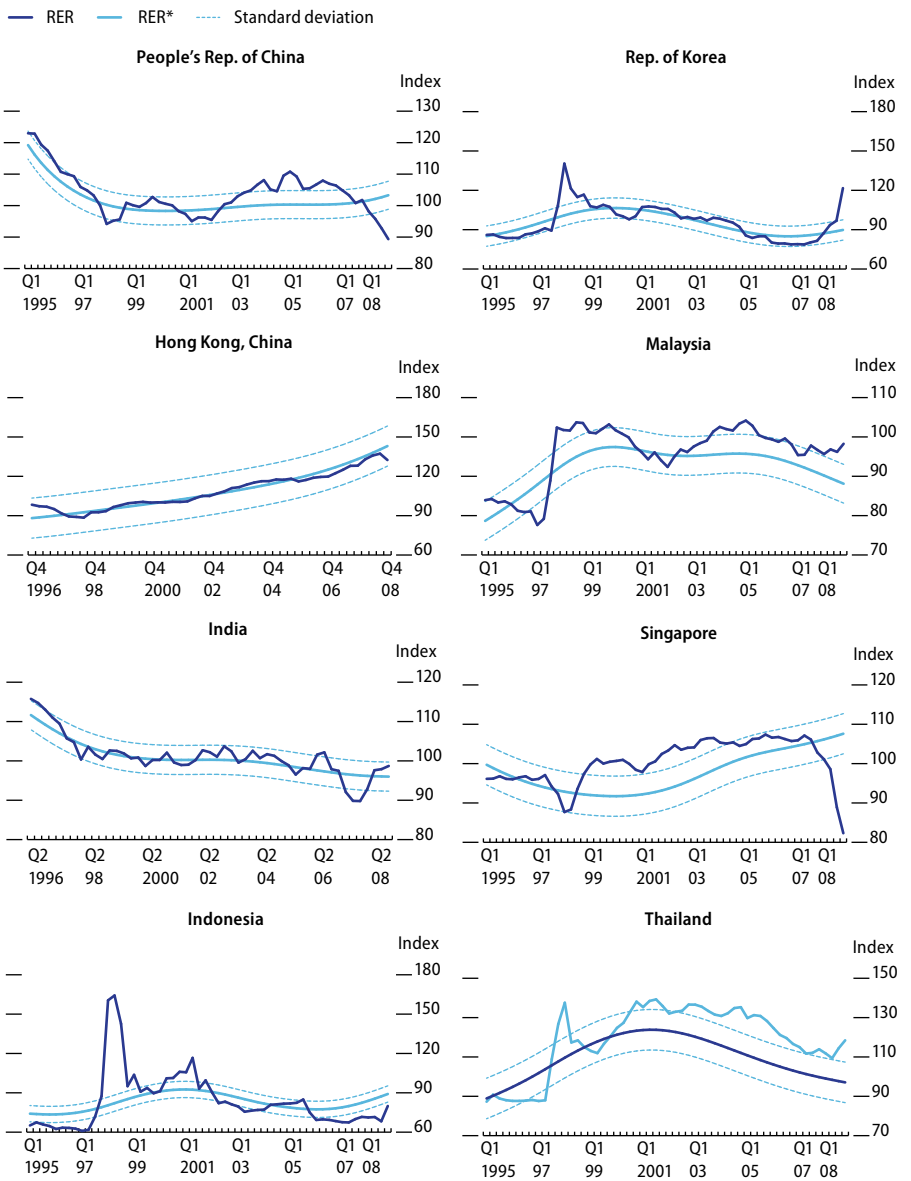
The first involves estimating the relationship between the actual *RER* and the prevailing economic fundamentals provided in (2). The second is to use the estimated coefficients together with the economic fundamentals in calculating the equilibrium real exchange rate. While economic fundamentals tend to involve both transitory and permanent components, to derive the (long-run) equilibrium real exchange rate, a Hodrick-Prescott Filter is applied to derive the permanent components of the economic fundamentals.

Source: Jongwanich, J. 2009. "Equilibrium Real Exchange Rate, Misalignment and Export Performance in Developing Asia," Economics Working Paper Series No. 151, Asian Development Bank, Manila.

country's export and trade performance. Appreciation of a country's real exchange rate worsens its cost competitiveness, in the process reducing exports (and trade surpluses), especially for labor-intensive products. In particular, when there is persistent misalignment of the real exchange rate—deviation of the real exchange rate from its (long-run) equilibrium level determined by economic fundamentals—a country's export and trade performance can be severely affected (Box 2.5.3). The recurrence of real exchange rate misalignment can potentially hamper economic growth over the medium and long term (Edwards 1989).

Figure 2.5.3, however, shows that numerous Asian economies experienced depreciation of their real exchange rates after the Asian crisis, which may have contributed to the notable trade surplus in the

2.5.3 Real exchange rate misalignment in developing Asia, selected economies



RER = real exchange rate; RER* = equilibrium real exchange rate.

Notes: An increase in RER refers to real exchange rate depreciation. When the actual real exchange rate exceeds the equilibrium level, this refers to undervaluation.

Source: Staff estimates. *Click here for figure data*

region. The PRC had a record $256 billion trade surplus with the US in 2007, which allowed its foreign currency reserves to surpass those of Japan. This made the PRC the largest holder of reserves in the world. The PRC's real exchange rate tended to depreciate during 1998–2006. In particular, when the real exchange rate is compared to its (long-run) equilibrium level, undervaluation was revealed in 1995–2007, with a notable undervaluation in 2003–2006 of approximately 10%.[17] However, the PRC began a gradual revaluation of the yuan against the US dollar in July 2005, mainly in response to pressure from the US. The real exchange rate showed an appreciating trend, mainly because of appreciation of the nominal (effective) exchange rate. By 2008, overvaluation of the real exchange rate was indicated.

Real exchange rate depreciation is also seen in other regional economies after the Asian crisis, such as Hong Kong, China; Thailand; and Malaysia. While the real exchange rate depreciation in Hong Kong, China was consistent with economic fundamentals, the real exchange rate was undervalued by almost 15% in Thailand and by around 10% in Malaysia in 2001–2008. In Singapore, the real exchange rate depreciated after 1998; however, since the third quarter of 2007, significant appreciation of the real exchange rate was evident.

In some Asian economies though, the real exchange rate exhibited an appreciating trend. In India, it has appreciated since 1996, and in 2008, appreciation was almost 20% relative to 1996. Such an appreciation may be contributing to the India's persistent trade and current account deficits. In Indonesia and Korea, the real exchange rates appreciated by 33% and 18%, respectively, during 2001–2007. Nevertheless in Korea, because of a noticeable depreciation of the nominal exchange rate in 2008, the real exchange rate showed a significant depreciation, and for the year the real exchange rate was undervalued by 13%.

Rebalancing trade

The need to rebalance trade

To date, most projections of the financial crisis have been derived using macroeconomic models of consumption and investment. While these models are appropriate for broad economic predictions, especially the way in which they model money and finance, they lack a full complement of information on global industry structure and trade—the exact mechanisms through which developing Asia is likely to be hit by the current crisis. In this subsection, a computable general equilibrium model is used to answer the question regarding how the recession in OECD countries and the attendant drop in consumption and imports will affect developing Asia's trade and growth.[18]

Asian economies are feeling the pinch of reduced spending in OECD countries on their goods and services exports. Simulations for 2009 and 2010 follow the international baseline assumptions from Part 1 of *ADO 2009* (Table 1.2.1). The impact of the slowdown in the OECD economies on real economic growth in developing Asia is simulated by comparing projected growth in 2009 and 2010 with what growth would

have been if the OECD had continued to enjoy the same average growth that took place over 2002–2007.

By the end of 2010, most Asian economies will experience real GDP of 6.0–10.2% less than they would have if growth in the OECD had stayed as high as in the precrisis baseline. This cumulative loss is a direct result of the financial crisis in the high-income OECD countries. The PRC and India will be impacted the most by the end of 2010, with their real GDP reduced by 9.0% and 10.2%, respectively, from their baseline potential. Most of this growth loss stems from the estimated reduction in real exports from developing Asia to OECD countries (down $79.9 billion in real 2004 prices in 2009 alone).

Most of the export volume decline is accounted for by high-income OECD markets, but a significant amount of intraregional exports will also be affected. The simulated changes in real exports, by each subregion and by industry (Table 2.5.1) indicate that the PRC will have the largest absolute loss followed by East Asia and Southeast Asia. India and South Asia also sustain losses in textile and clothing exports that are substantial. Exports of heavy manufacturing and electronics from Asia lead declines by nearly two times the volume changes in all other products.

Global and regional actions

The growing specter of protectionism will complicate developing Asia's efforts to achieve a more balanced trade structure. That structure ultimately depends on a robust domestic economy with a healthy appetite for imported capital and consumer goods. Protectionist policies, in contrast, constrain the dynamism of the domestic economy by impairing

2.5.1 Projected 2009 change in real exports by region and commodity ($ million, 2004 prices)

	People's Republic of China	Rest of East Asia	India	Rest of South Asia	Malaysia	Singapore	Rest of Southeast Asia	Other developing Asia	Total
Agriculture	-233	-57	-341	-42	-17	-12	-347	-56	-1,105
Electronics	-7,018	-6,683	-34	-2	-2,578	-1,799	-2,535	-4	-20,652
Extraction	-516	-336	-302	-7	-356	-328	-1,094	-702	-3,642
Heavy manufacturing	-7,774	-7,594	-870	-68	-1,136	-1,478	-2,588	-344	-21,850
Light manufacturing	-4,984	-1,235	-622	-47	-424	-171	-1,405	-63	-8,950
Motor and transport equip.	-1,003	-1,912	-105	-6	-80	-111	-420	-38	-3,675
Other services	-435	-1,440	-410	-61	-115	-618	-237	-126	-3,442
Processed foods	-628	-189	-117	-53	-306	-78	-818	-80	-2,270
Textiles, apparel, leather	-3,895	-1,711	-449	-473	-101	-50	-1,043	-328	-8,049
Transport and construction	-1,111	-3,008	-151	-75	-187	-443	-636	-183	-5,793
Travel, recreation, and tourism	-127	-156	-10	-8	-76	-20	-91	-8	-495
Total	-27,725	-24,320	-3,411	-843	-5,375	-5,107	-11,212	-1,932	-79,925

Notes: Simulation results make use of the latest version of GTAP data base using 2004 trade flows in constant 2004 dollars. The simulation is based upon a comparison of exports that would have taken place if the high-income OECD economies had grown in 2009 at the same rate they averaged over 2002–2007 and the growth rate assumed in *ADO 2009* baseline assumptions. See Minor and Greenbaum (2009) for details and methodology.

Rest of East Asia includes Hong Kong, China; Democratic People's Republic of Korea; Republic of Korea; Macau, China; Mongolia; and Taipei,China.

Rest of South Asia consists of Bangladesh, Bhutan, Nepal, and Sri Lanka.

Rest of Southeast Asia includes Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Myanmar, Philippines, Thailand, Democratic Republic of Timor-Leste, and Viet Nam.

Totals are for countries and regions listed (and differ from the global total).

Source: P. Minor and A. Greenbaum. 2009. "Financial Contagion and Asian Trade and Growth—The Transmission of Financial Distress in the High Income OECD to Asian Economies." Background paper prepared for *Asian Development Outlook 2009.* Asian Development Bank, Manila.

both static and dynamic efficiency. Further, by artificially raising the cost of imports, protectionism harms consumption and investment.

The political temptation to erect trade barriers to protect domestic firms and jobs is understandable in light of the severe global downturn. In fact, most of the world's major economies have already put into effect various forms of protectionism. The substantial amount of aid given to automobile manufacturers around the world, totaling about $48 billion (Gamberoni and Newfarmer 2009), is a case in point.

Some worrying signs of protectionism are also surfacing within developing Asia. For example, Indonesia has restricted the import of certain goods to just a few ports and airports, while India has increased tax rebates for exporters. While it would be prudent for regional countries to refrain from pursuing such self-defeating policies, protectionism is a global problem requiring a concerted global effort to find a solution. Reaching consensus on a broad multilateral trade agreement is unlikely in the current environment. A feasible alternative could be a multilateral forum with the more limited, but equally important, objective of preventing creeping global protectionism.

While helping retain past gains in free trade, greater cooperation among developing Asian countries can also promote a more balanced trade structure. Intra-Asian trade has grown rapidly in recent years, but it is still largely based on intermediate rather than final goods. The trade structure remains heavily dependent on demand for final goods from the US and Europe. Essentially, if the entire region is viewed as a single economy, it suffers from an excessive dependence on external demand. Removing trade barriers among countries within developing Asia—most ideally in the form of unilateral policy reforms implemented according to a regionwide action plan and done on a most favored nation basis—would help stimulate intraregional trade and hence the "domestic" economy of the region.

In addition, intraregional trade facilitation would reduce the cost burden arising from trade-related regulations and thus further stimulate intraregional trade. A larger pan-regional market is conducive to economies of scale and specialization, and thus intra-industry trade in differentiated products. At the same time, more robust domestic demand in individual countries would increase the demand for final goods and thus increase the relative importance of final goods in intraregional trade. Further, intraregional exchange rate policy dialogue or coordination could also promote intraregional trade and investment by maintaining stability among regional currencies. Finally, in harmony with global efforts to resist protectionist tendencies, governments in developing Asia could also forge a regionwide agreement to halt any new protectionist measures.

Conclusions

The changing trade patterns in developing Asia have made real exchange rates less effective in influencing trade balances and export patterns than during previous crisis periods. Trade is now dominated by MNEs and production networks within the region. External demand in the high-income OECD countries has become more rather than less important for

developing Asia's manufactured exports. Thus, the severe downturn in the major industrial economies will have a severe impact on trade and growth in the region. The implications include the need for developing Asia's policy makers to put more emphasis on domestic demand, take steps to reorient trade in final goods within the region, and strongly resist any new protectionist measures in the region.

Pressure for protectionism is growing throughout the world. Even within WTO commitments, there is room for developing countries to increase tariffs, but such measures would be self-defeating. The simulations in this part of *ADO 2009* indicate that countries that resort to protectionism will likely see their GDP growth suffer. Notably, Southeast Asian countries would be the most affected by protectionism: if they raised their tariffs the maximum allowed under WTO commitments, the impact on GDP would be negative and as large as that of the recession in OECD countries.

Policy implications: A new growth strategy for developing Asia?

Shifting to a more balanced growth model is in developing Asia's own self-interest. The pronounced impact on the region's growth of the current synchronized recession in the G3 underlines the risks of excessive dependence on external demand. Export-led growth has delivered enormous benefits to the region and will continue to do so. However, its large and persistent current account surpluses—which emerged only after the Asian crisis—are an integral part of the global imbalances that contributed to the unfolding global financial crisis. Even in the absence of the current financial meltdown, the region may have been paying a heavy price for its output–expenditure imbalance. This price includes not only welfare costs associated with consuming too little, but also opportunity costs arising from failure to use savings productively.

Looking ahead, the key question for Asian policy makers is how to strengthen domestic demand in response to weakened external demand. Given the diversity of the nature and underlying causes of developing Asian countries' current account positions, the optimal policy mix for rebalancing will necessarily differ from country to country.

Nevertheless, effective rebalancing will generally require a mix of demand-side policies and supply-side policies. The excess of output over expenditure in developing Asia stems partly from a mismatch between the structure of supply and the structure of demand. Rebalancing, therefore, involves altering the production structure.

A number of policies directly influence demand and supply, and thus directly help resolve the structural mismatch. These must be complemented by policies that facilitate both supply and demand adjustments, such as those related to financial development and the exchange rate.

Finally, there are clear limits to which a country's own policies can bring about more balanced growth. For one, a concerted global effort is required to effectively address global imbalances that are, after all, a global problem with global causes and effects. Further, strengthening regional cooperation can help the region better cope with adverse external shocks.

Policies to strengthen domestic demand

The most direct means for regional governments to reduce the region's excessive dependence on external demand is to implement policies that boost domestic demand. In principle, those policies can be targeted at either encouraging greater consumption or stimulating investment. However, the empirical results in the section *Saving, investment, and current account surplus in developing Asia* suggest that strengthening

domestic consumption holds the key to more balanced growth in developing Asia. In addition, fiscal policy can make a substantial contribution toward making domestic demand more robust in both the short run and long run. Below are some specific policies for boosting domestic demand in developing Asia.

Policies that transfer more corporate saving to households and that dilute the precautionary motive for saving among households will strengthen domestic consumption

Transferring corporate saving

The bulk of developing Asia's net saving comes from private rather than public saving. High saving rates are driven largely by high corporate profits in several countries. This has adverse implications for consumption if these profits are not transferred to the household sector. In particular, in the case of the PRC, narrow ownership of stocks among the public limits the scope for transferring corporate profits to households. This scope is further restricted by the tendency of even publicly listed PRC firms to use their profits to finance investments rather than to pay dividends. The logical policy implication is that the region's governments should consider encouraging firms to pay dividends to stockholders. They should likewise promote corporate governance and use the tax system to distribute profits to households. Such policies will strengthen the link between corporate profits, household income, and consumption.

Diluting the precautionary motive

In addition, government can help reduce incentives for households to engage in precautionary saving, which has risen since the Asian crisis. In particular, policies that mitigate the risk and uncertainty that households face will encourage them to save less and spend more. To some extent, greater state provision of health care, education, and pension benefits will substitute for private consumption (though reducing risk and uncertainty surrounding health care spending will likely result in higher levels of spending overall). More generally, more extensive social safety nets will boost consumer confidence and consumption.

Enhancing the investment climate is a greater priority than expanding investment

Although the empirical analysis presented in this part of *ADO 2009* is far from definitive, it fails to yield any significant evidence of underinvestment in the region. In a quantitative sense, such investment may be more or less at the "right" level, which weakens the case for policies that directly promote accumulation of capital. Instead, policy makers should concentrate on enhancing the investment climate which, throughout the region, still lags far behind the world's most competitive economies.

For instance, the poor overall investment climate of Indonesia and the Philippines is rooted in serious shortcomings in their institutions, in particular institutions of government, such as widespread corruption,

weak contract enforcement, and arbitrary changes in regulations. Malaysia and Thailand, middle-income countries seeking to move up the global value chain, have stronger institutions, but face different sets of challenges in creating a more attractive investment climate. In particular, their shortage of skilled and professional workers is constraining investment in several industries. Related to the shortage of skills in those two countries is a shortage of capacity for absorbing advanced technologies.

At a broader level, although specific weaknesses in the investment climate differ across countries, remedying those weaknesses will help channel more domestic saving into domestic investment. Financial development and fiscal policy can both make substantial contributions to improving the investment climate.

Expansionary fiscal policy to mitigate weak short-run external demand can lay the foundation for more robust domestic demand

Short-term imperatives have driven the unprecedented regionwide effort to boost aggregate demand through a combination of higher government spending and tax cuts. Most economies in the region have relatively ample fiscal space for pursuing expansionary fiscal policy. Although Asian governments' efforts to bolster domestic demand do not necessarily entail deliberate efforts to rebalance demand and growth, yet these efforts will end up doing exactly that in the short run.

After that period, fiscal policy can facilitate more permanent rebalancing by the private sector. For example, strengthening health care, pensions, education and social safety nets will require substantial fiscal resources in the medium term, but will lay the foundation for more sustainable consumption. Another example is government investment in physical infrastructure (roads and ports) and social infrastructure (education), both of which raise the return to private investment. The existence of strong complementarities between public and private investment means that public investment can substantially improve the investment climate. By the same token, inadequate public investment is a major source of a poor investment climate.

Policies to alter the production structure

As noted earlier, developing Asia's current account imbalances partly reflects a structural mismatch between the region's supply structure and its demand structure. Reducing the output–expenditure gap therefore requires not only policies that alter the structure of demand, but also policies that alter the structure of supply.

Supply-side policies that promote smaller companies and service industries will increase the relative importance of production for domestic demand

Increasing the internal dynamism of the domestic economy

Developing Asia's domestic economies have to become more dynamic if

they are to create an output structure catering to domestic demand more. Key structural measures are increasing the internal dynamism of regional economies by further deregulating tradable and nontradable sectors, reducing barriers to entry and exit, and promoting greater competition in areas such as telecommunications, public utilities, and service industries.

To promote competition, policy makers should pay greater attention to reducing the costs of new-firm entry, easing cumbersome licensing systems, and removing features of tax systems that raise the costs of setting up new businesses. These measures are particularly beneficial for the small- and medium-size enterprises that usually dominate service industries. More flexible and efficient labor markets will also promote the internal dynamism of regional economies.

From a broader perspective, internal dynamism will require a larger role for knowledge-based industries and innovative economic activities. Successful development of such industries and activities depends on technological progress and accumulation of human capital.

Changing the structure of output

A legacy of the regionwide trend toward export-oriented industrialization is a set of policy distortions that favoring manufacturing over services and hence production of tradables over nontradables. In particular, interest rate controls kept the cost of capital artificially low for the select few firms with access to capital—primarily large manufacturers that dominated the export sector. This has led to a capital-intensive pattern of growth and development throughout developing Asia. It has also constrained the access of small and medium-sized enterprises to bank loans and has thus stunted their growth.

Regional governments have also deliberately given preferential tax treatment and other fiscal incentives to export-oriented manufacturers as a means of fostering their growth. In some countries, policy distortions included underpricing of key manufacturing inputs such as land, energy, electricity, water, and the environment. Removing pro-manufacturing and pro-export policy distortions will be critical to aligning Asia's supply structure more closely with its demand structure.

Promoting competition

Competition increases the efficiency of industry in both static and dynamic terms, and thus contributes to the internal dynamism of Asian economies. Such efficiency gains are likely to be especially large in the region's service industries, which cater largely to domestic demand. In those industries, policy distortions have stifled competition in many countries. Given the central role of financial underdevelopment in the region's unbalanced growth, promoting competition in the financial sector will be vital. Greater competition can also boost demand, in particular consumption, by bringing about lower prices and thus increasing the purchasing power of households.

Policies to facilitate the supply–demand balance

In addition to policies that boost domestic demand and policies that align the output structure more closely with domestic demand, financial-

development and exchange-rate policies can facilitate the adjustment of both supply and demand toward a more balanced structure. In that way, those policies can accelerate the process of the rebalancing that has been set in motion by demand-boosting and supply-realigning policies.

Accelerating financial development will channel more of Asia's savings into investment within Asia, and contribute to an output structure more closely aligned with domestic demand

On the demand side, financial underdevelopment can have a negative effect on both investment and consumption. Their recent troubles notwithstanding, the financial markets of New York and London are far deeper, broader, more liquid, more innovative, and more sophisticated than those in developing Asia. This helps explain Asia's marked preference for investing its savings abroad rather than at home, which, in turn, contributes to its large and persistent current account surplus.

Financial development will channel domestic savings into productive investment rather than low-yielding foreign government bonds. At the same time, it lessens the need for precautionary household saving and thus encourages greater consumption.

On the supply side, a paucity of new financing keeps down the number of business startups, which are essential to a dynamic domestic economy. Policy makers should therefore strive to facilitate firms' access to new financing, in particular from commercial banks, which still form the backbone of Asian financial systems. They should also speed up the development, and improve the efficiency, of domestic capital markets so as to provide alternative channels of financing for such startups. New firms are especially important in knowledge-based industries—again, vital for internal dynamism.

More generally, small- and medium-sized firms tend to predominate in the services sector, which caters largely to domestic demand. So, ensuring that such firms have adequate access to credit will help align the output structure toward domestic demand.

More flexible exchange rates will promote consumption and induce a sector reallocation of production

In the context of monetary and exchange rate policy, the key is to speed up the region's move away from tightly managed exchange rate regimes toward a more flexible approach. The ongoing unwinding of global imbalances, in particular the sharp slowdown of the US economy and the continuing fragility of the US financial system, is likely to weaken the dollar at some point. This will unleash upward pressure on Asian currencies.

On the demand side, the immediate impact of stronger regional currencies is that of lowering the price of imports, which would stimulate consumption. More generally, currency appreciation raises the purchasing power of households and thus raises their consumption potential. On the supply side, stronger regional currencies will raise the relative price of the region's exports and thus damp external demand for them.

This relative price change will contribute to a reallocation of resources

from the production of tradables to nontradables, including services. More flexible exchange rates will also enable Asian countries to adopt their own monetary policies, which will enable them to cope better with weakening external demand. In short, exchange rate flexibility promotes rebalancing by boosting demand as well as increasing the share of nontradables in total output.

Global efforts and regional cooperation

The burden of adjustment in the unwinding of global imbalances cannot fall entirely on the economic policy of one country. The underlying reason is simple: global imbalances are a global problem, and their resolution requires a global effort. Greater regional cooperation will also help Asia weather the next external shock.

Resolving global imbalances requires global efforts

The unprecedented magnitude of the US current account deficit and level of net foreign indebtedness is neither desirable nor sustainable. Preventing its disorderly unwinding requires global economic rebalancing. The current global crisis shows that inappropriate policies and poor governance in industrial countries can severely harm the growth and welfare of developing countries. Therefore, industrial economies need to improve their financial regulatory framework and the quality of their macroeconomic policy management. Some form of international dialogue is necessary for ensuring that the governments of all countries—even large industrial countries—take into account the negative spillover effects of their unsound policies on the rest of the world.

The current crisis also calls for a reform of the global financial architecture. The existing global reserve system is largely based on self-insurance, with each country building up its foreign exchange reserves as a buffer against unexpected shortages of foreign exchange liquidity. This has played a role in the emergence of global imbalances by encouraging developing countries, especially in Asia, to build up their own sizable reserves by persistently running current account surpluses. The world therefore needs to fortify the current reserve system, including a hefty increase in IMF resources. However, it is critical to reform IMF governance to help restore the region's confidence in that body, which eroded during the Asian crisis. More specifically, IMF's internal governance structure must change to give developing countries, particularly in Asia, a voice more appropriate to the region's share of world output and trade.

Intensifying regional cooperation will strengthen buffers against large external shocks

The unfolding crisis could damage intra-Asian trade. Although such trade has grown rapidly in recent years, much of it involves sending parts and components to the PRC for assembly into final goods for export beyond the region. Intraregional trade therefore remains hostage to extraregional demand.

As pointed out in the section *Causes and consequences of global imbalances: Developing Asia's perspective*, one byproduct of more robust regional domestic demand will be more substantive EU-style intraregional trade that is less dependent on external demand. However, concrete steps to promote regional trade, in particular forming an inclusive free trade area covering much of the region, will accelerate the process. A larger Asian market will allow for economies of scale, encourage greater specialization, and so increase the scope for intra-industry trade in differentiated products.

Domestic demand expansion and intraregional trade liberalization can form a mutually reinforcing virtuous circle. A strong case for foreign exchange policy dialogue or coordination can likewise be made. Maintaining the stability of currency movements between regional trading partners can facilitate intraregional trade and investment flows.

Concluding observations

Developing Asia's policy makers have several sets of policy options at their disposal for rebalancing growth toward domestic sources and weaning the region away from excessive dependence on demand in the G3. One set is geared toward boosting domestic demand so that domestic consumers and firms can buy more of what the domestic economy produces. Another set aims to alter the structure of output so that it becomes more closely aligned with domestic demand, for example by removing policy distortions that favor manufacturing over services.

Yet a third set, pertaining to financial development and adjustment of the exchange rate, can promote a better balance between demand and supply by influencing both components. A fourth set is not domestic in scope, but rather requires greater policy dialogue or coordination, both regionally and globally.

A single policy will have little impact in terms of engendering more balanced growth. Taken together, these policies will make a significant contribution to reducing the region's excessive dependence on external demand.

Endnotes

1 Data are taken from the October 2008 issue of the International Monetary Fund's *World Economic Outlook* database. The various regional groupings generally follow International Monetary Fund (IMF) conventions with the following exceptions. As used in this part, developing Asia includes the newly industrialized economies of Hong Kong, China; Korea; Singapore; and Taipei,China; as well as the developing Asian economies as defined by IMF. Europe is defined to include the European Union as well as the emerging market countries of Central and Eastern Europe. The group Middle East and the Russian Federation includes all members of the Commonwealth of Independent States. Western Hemisphere excludes the US and refers to Latin American and Caribbean countries. Data for 2008 are IMF estimates.

2 Emerging Europe rather than Europe as a whole is analyzed due to the absence of data on capital flows for the eurozone. The United Kingdom is also excluded.

3 Aggregates for developing Asia tend to be dominated by the PRC, given its economic size and external performance. Within developing Asia, financing of current account imbalances is much more diverse.

4 The recent widening of Malaysia's current account surplus mainly reflects elevated commodity prices.

5 Broadly speaking, financial development refers to the development of broader, deeper, and more liquid financial markets. It denotes the development of sounder and more efficient banking systems as well as liquid and well-functioning capital markets, that is, equity and bond markets. Financial development brings about a more efficient allocation of resources by directing capital toward the most productive firms, industries, and activities. The subsection *Modeling saving behavior* discusses the underlying rationale behind the positive and negative effects.

6 The term Bretton Woods II is a reference to the Bretton Woods system of pegged but adjustable exchange rates that was in effect between 1945 and the early 1970s.

7 Even though most economies in the region do not report the currency composition of their reserve holdings, US and IMF data suggest that the bulk of the region's reserves continue to be held in US dollar assets (Setser 2008).

8 Though a certain degree of caution is warranted when investing excess reserves in equities and other riskier assets, as highlighted by the plunge in global equity markets.

9 However, just before the crisis, excessive current account deficits in some countries contributed to its outbreak.

10 In the short run, output fluctuations are driven mainly by changes in labor input. However, in the medium or long run, output growth is driven mainly by technological progress and capital accumulation. If the economy is in a transition period, as is likely the case in most countries in developing Asia, capital accumulation is the main source of growth. In the Solow model, growth during the transition period is temporarily high as the economy catches up with rich economies by accumulating capital. Even in steady state, in which both technological progress and capital accumulation matter, it is easy to show that the growth rate of output is equal to the growth rate of capital if technological progress is labor augmenting.

11 A recent example of a study based on household data is Demery and Duck (2006).

12 See Jha et al. (forthcoming) for more discussion on the theories of household saving behavior and evidence in Asia.

13 The analysis of detailed trade data in this section uses the United Nations Commodity Statistics Database (UNCOMTRADE), based on Revision 3 of the Standard International Trade Classification, and Bureau of Foreign Trade for Taipei,China. Unless specified, trade in this subsection refers to manufacturing trade.

14 NAFTA accounted for 35.7% of total textile and clothing exports in Southeast Asia and the EU15 accounted for 43.3%, in 2005–2006.

15 Such as local firms that improve productivity by adopting technology from MNEs or former employees who start their own factories.

16 The real exchange rate (*RER*) is a broad summary measure of the prices of one country relative to the prices of another country or group of countries, both expressed in a common currency. It can generally be expressed as $RER = eP^*/P$, where e is the nominal exchange rate (defined as units of home currency to a unit of the foreign currency), P^* denotes the foreign (world market) price level, and P is the domestic price level. An increase in *RER* refers to real depreciation. See the detailed concept and measurements of *RER* in Jongwanich (forthcoming).

17 The undervaluation revealed here is smaller than that estimated by some other empirical studies. For example, Goldstein (2004) and Frankel (2005), respectively, found that in 2000, the PRC's real exchange rate was undervalued by 15–25% and 35%. Cheng and Orden's (2005) estimates of the equilibrium real exchange rate for the period 1978–2002 found the PRC's real exchange rate to be undervalued by 22.7% in 2002. Only a few studies, such as Wang (2004), found no misalignment in the PRC's real exchange rate after 1995.

18 The model, data, and methodology used in deriving the simulation can be found in the background paper to this part of *ADO 2009* (Minor and Greenbaum 2009).

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Part 3

Economic trends and prospects in developing Asia

Central Asia

Armenia
Azerbaijan
Georgia
Kazakhstan
Kyrgyz Republic
Tajikistan
Turkmenistan
Uzbekistan

Armenia

The global economic slowdown and conflict in Georgia have severely affected Armenian growth. Remittance inflows, higher incomes, and robust private investment continued to fuel aggregate demand in 2008, while construction and services continued to drive growth on the supply side. The sharp deceleration of the Russian economy, reduced inflows of workers' remittances and foreign investment, and a bleak outlook for commodity exports will diminish growth in the short term. To sustain growth, the authorities will have to diversify the economic base and continue implementing structural reforms.

Economic performance

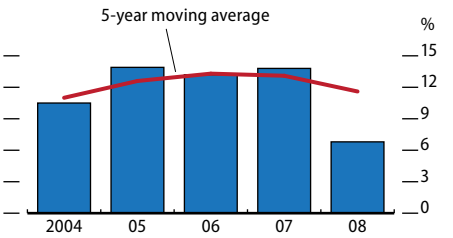
Armenia is a small, open economy that relies heavily on remittances, foreign investment, and imports. It is also landlocked by four countries. The conflict between Georgia and the Russian Federation in August 2008 and the resultant disruption of trade, as well as the global economic slowdown, therefore had a significant impact on growth, which slumped to 6.8% (Figure 3.1.1).

On the aggregate demand side, private consumption and investment continued to buttress growth through most of the third quarter, underpinned by greater inflows of workers' remittances, increased domestic wages, and larger foreign direct investment (FDI). Most private investment was channeled into construction and mining, and public investment into developing and rehabilitating public infrastructure. However, as the domestic economy is heavily dependent on developments in the Russian Federation, the collapse of the stock market and the sharp downturn of that economy toward the end of the year stanched both remittances from Armenian workers there (the source of 75–80% of remittances) and FDI inflows from Russian investors. Net exports of goods and services made a sizable negative contribution to GDP growth.

Growth in aggregate supply was led by services and construction, while industrial production and agriculture lagged (Figure 3.1.2). Services expanded by 9.0%, driven by growth in communications and trade (including wholesale and retail trade). Construction grew by 7.2%, reflecting the development of residential and commercial buildings in Yerevan, and the expansion of production capacity in, mainly, mining and processing industry.

Industrial production was sluggish in 2008, growing by only 2.4%. This outturn reflected weakening foreign demand and prices, which hit mining especially hard, rising by only 1.5%. Metallurgy declined by 8.6%. Manufacturing output of precious metals and stones continued to tumble, by 14.3%. The chemical industry also experienced lower output from reduced foreign demand. In contrast, production of electricity, water, and

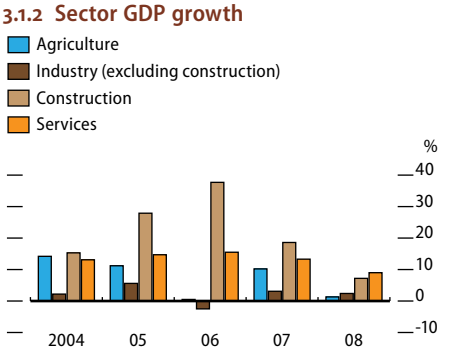
3.1.1 GDP growth



Source: National Statistical Service of the Republic of Armenia, available: http://www.armstat.am, downloaded 3 March 2009.

Click here for figure data

3.1.2 Sector GDP growth



Source: National Statistical Service of the Republic of Armenia, available: http://www.armstat.am, downloaded 3 March 2009.

Click here for figure data

This chapter was written by Philip Chang of the Central and West Asia Department, ADB, Manila.

gas rose by 8.0%. Agriculture performed poorly, expanding by only 1.3% due to low yields of grapes, wheat, and other nonirrigated crops.

Inflation accelerated to average 9.0% in 2008 from 4.4% the prior year—or significantly above the inflation target of 4.0%, plus or minus 1.5%. In the first half, record prices of food (such as grains, vegetable oil, and butter) and energy were the main culprits for the marked rise in inflation. The combined effect of the removal of the gas subsidy for households and industry on 1 May 2008, a 17.4% increase in nominal average monthly wages during the year, and monopolistic or oligopolistic practices of producers and importers of certain products also contributed to the growth in the price level. Inflation reached a peak of 11.5% year on year in August, before moderating to 5.2% in December (Figure 3.1.3).

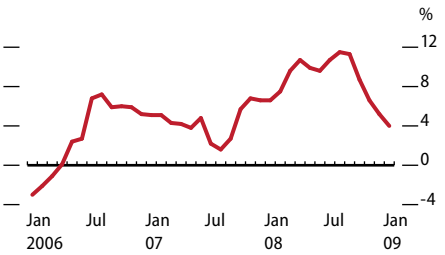
Monetary factors added to the inflation pressures. M2x expanded by an annual average of 31.6% in 2008. Growth was high mainly in the first half of the year, and slowed considerably in the fourth quarter for a year-on-year increase of 2.4% at year-end (Figure 3.1.4). To tame inflation and anchor expectations, the Central Bank of Armenia raised the refinancing interest rate (its main policy instrument) on several occasions, from 5.75% at the start of the year to a peak of 7.75%. However, as the global downturn accelerated, prices of food, energy, and commodities fell significantly, easing inflation pressures considerably and allowing the central bank to lower the refinancing rate to 7.25% on 2 December.

The International Monetary Fund (IMF), under its Article IV findings for Armenia released in January this year, noted that the authorities maintained the fluctuation of the exchange rates within a narrow band in 2008 on concern about the potential destabilizing effects of political uncertainty and the Georgian conflict. Subsequently on 3 March 2009, in connection with obtaining a standby arrangement with the IMF, the central bank announced that it would no longer intervene in the market except to smooth "extreme volatility." After the announcement, the dram depreciated by about 20%, and has remained at around that level (Figure 3.1.5).

The fiscal policy stance was consistent with macroeconomic stability. The Government is committed to implementing a sound fiscal policy to curtail inflation expectations. The budget deficit is estimated at AMD23.2 billion in 2008, about 0.6% of GDP (Figure 3.1.6). Total fiscal revenue (including nontax receipts and grants) in 2008 came to AMD787.4 billion, and total expenditure to AMD810.6 billion. Total receipts rose by 33.9%, primarily on higher tax collection: value-added tax was up by 20.9% (mainly from growth of imports) and income tax by 14.8%. Fiscal expenditure increased by 27.7%; 88.5% was current spending such as wages, subsidies, interest payments, and goods and services, and 11.5% public capital outlays.

Although the tax-to-GDP ratio climbed to 16.4% of GDP in 2008 from 16.1% in 2007, it remained low because of widespread tax evasion, weakness in tax administration, excessive exemptions that limit the tax base, and heavy reliance on indirect taxes. The major contributors to economic growth—construction and services—have largely escaped the tax net. Lack of buoyancy in the services tax stems from the fact that it is

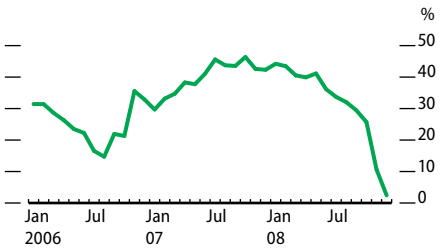
3.1.3 Inflation



Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 3 March 2009.

Click here for figure data

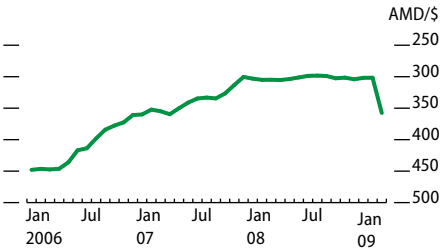
3.1.4 Money supply (M2x) growth



Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 3 March 2009.

Click here for figure data

3.1.5 Nominal exchange rate



Note: March 2009 figure refers to 10 March data.

Sources: International Monetary Fund, *International Financial Statistics* online database; Central Bank of Armenia, downloaded 3 March 2009.

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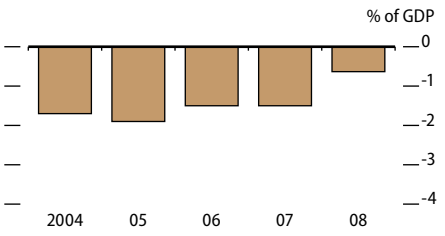
3.1.6 Budget balance



Source: Ministry of Finance and Economy, available: http://www.mfe.am, downloaded 10 March 2009.

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specific rather than ad valorem. Foreign and joint-venture companies are the top taxpayers; many large domestic enterprises do not pay tax.

The total value of goods exported was only $1.1 billion in 2008, down by 7.2% from the previous year (Figure 3.1.7). The sharp fall in the value of exports in the mining, diamond processing, and metallurgy subsectors was largely responsible for the decline. The total value of goods imported leaped by 35.0%, to around $3.8 billion, on higher international food and energy prices, and on buoyant demand for consumer goods, including automobiles. Investment in mining and construction boosted spending on imports of machinery and equipment, and building materials. The trade deficit deteriorated markedly in 2008 to around $2.7 billion.

A services trade deficit of $310 million is estimated for 2008. This was largely due to the double-digit growth in services imports, particularly transport and insurance services, the costs of which jumped as a result of the Georgian conflict. Although remittances helped offset a widening trade gap, the current account deficit is estimated to have surged to $1.4 billion (11.5% of GDP) in 2008 (Figure 3.1.8). This extremely large deficit is a particular concern. Most of it was financed by FDI, increased external borrowings, and a drawdown on gross international reserves (Figure 3.1.9).

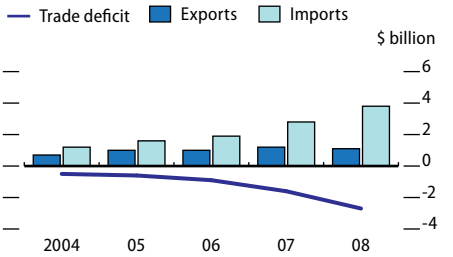
Gross official international reserves fell by 15.3% to $1.4 billion in December 2008, equivalent to just more than 3.6 months of imports of goods and services. The authorities have been in negotiations with governments and international financial institutions to secure external financing to cover the balance-of-payments deficit.

External debt is estimated to have reached about $1.7 billion in 2008, 14% higher than the previous year (Figure 3.1.10). Continued official emphasis on a sustainable debt management policy has seen a notable reduction in external public debt as a share of GDP in recent years. It is expected to be about 13.8% of GDP in 2008, with most of the outstanding debt contracted on concessional terms.

The new Government is committed to tax administration and customs reform. It restructured the Tax Administration Department of the State Tax Service to improve administration and collection. It also approved a new tax administration reform package. For example, to make tax compliance simpler for small businesses, since January 2009 only companies with an annual turnover of at least AMD58.3 million have needed to register for value-added tax (VAT) purposes. The reform package also covers corruption control, facilitation of VAT reimbursement, and higher-quality services to taxpayers. The Government has conducted public campaigns to enhance the awareness of tax payment, introduced a self-declaration system for individual taxpayers as well as online tax registration, and created a customer relations department to answer tax queries.

Still, much remains to be done to move toward international best practice. According to the *Doing Business 2009* report, the country's ranking slid from 41 in 2007 to 44 in 2008 (out of 181 economies). In particular, the rankings for payment of taxes declined from 147 to 150 and investor protection from 84 to 89, but enforcement of contracts climbed from 63 to 61.

3.1.7 Merchandise trade balance



Sources: National Statistical Service of the Republic of Armenia, available: http://www.armstat.am, downloaded 3 March 2009; staff estimates.

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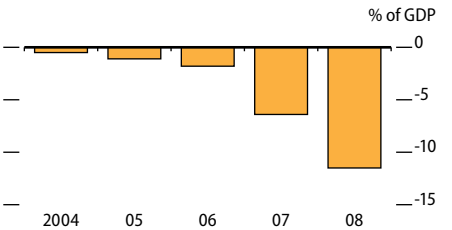
3.1.8 Current account balance



Source: National Statistical Service of the Republic of Armenia, available: http://www.armstat.am, downloaded 3 March 2009.

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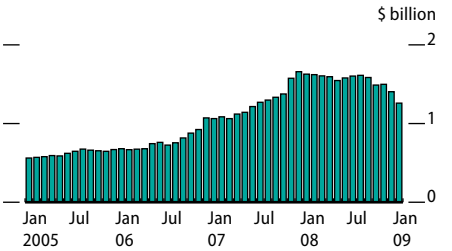
3.1.9 Gross international reserves



Note: Excluding gold.

Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 3 March 2009.

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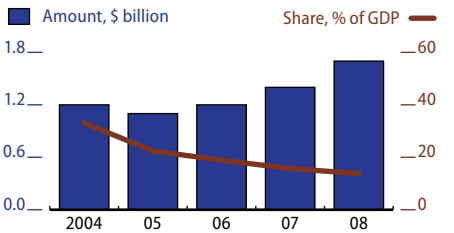
3.1.10 External debt



Sources: Ministry of Finance and Economy; National Statistical Service, available: http://www.armstat.am, downloaded 3 March 2009.

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Economic prospects

Developments internationally—especially in the Russian Federation—will impact on the performance of the Armenian economy. In particular, the rapid deterioration of the Russian economy is expected to severely curtail FDI into Armenia by Russian investors and the repatriation of incomes by Armenian workers there. The global slowdown will delay investment programs in construction, mining, and retail. Softer real estate prices in Armenia after a decade-long construction boom, as well as layoffs both at home and in the Russian Federation, are expected to reduce private consumption.

Services (and construction to a lesser extent) are expected to continue supporting what will likely be almost flat growth in 2009, of 0.5%. Reduced workers' remittances will damp consumption spending and imports. GDP growth is projected to pick up to 3.0% in 2010, on the assumption of a moderate recovery in the global economy.

Increased government expenditure is directed at promoting economic development. In the state budget for 2009, approved by Parliament, fiscal revenue is expected to reach AMD927 billion (21.7% of GDP), and fiscal expenditure AMD967 billion (22.7% of GDP), with a budget deficit of AMD40 billion (in contrast to an estimated deficit of AMD23.2 billion in 2008). However, the actual budget deficit may be much larger as tax revenue may shrink substantially on rapidly slowing economic activity. In addition, the authorities may have to step up fiscal expenditure this year to counter the downturn. Such additional spending would likely focus on social programs and infrastructure development.

Global demand destruction will lead to softer prices for imports of food and energy in 2009. Relatively tight monetary policy, too, will help ease inflation pressures. The dram is expected to depreciate against the US dollar, reflecting the 3 March decision to return to a floating exchange rate regime so as to cushion the economy from external shocks and to safeguard reserves. Inflation is put at 7.5% in each of the next 2 years.

The trade deficit is expected to remain wide in the forecast period because of the economy's reliance on imports. The outlook for exports is bleak, with international prices for commodities likely remaining low and external demand weak. Lower inflows of workers' remittances and other transfers are also projected. The current account deficit is seen widening to around 9.0% and 9.5% of GDP over the next 2 years. Inflows of FDI, capital grants, and foreign development assistance are expected to finance this heavy deficit, but if it exceeds projections, balance-of-payments difficulties may ensue.

Although the global financial crisis has not directly affected local banks so far, some of them are reliant on international institutional funding for domestic lending, and all of them will face increasing spreads on international loans on account of the disruptions to international credit markets.

3.1.1 Selected economic indicators (%)

	2009	2010
GDP growth	0.5	3.0
Inflation	7.5	7.5
Current account balance (share of GDP)	-9.0	-9.5

Source: Staff estimates.

3.1.1 Development challenges

The economic base is narrow, and the Government recognizes that to achieve a more diversified and sustainable growth path, it needs to capture a wider range of production activities in the value chain, broaden its sources of energy supply, and develop new areas, such as information technology and tourism. It has plans to promote greater private sector development in the economy. It also needs to push through institutional reforms in the judiciary and in competition policy.

Azerbaijan

Expansion of the hydrocarbon sector sustained strong economic growth, although the conflict between Georgia and the Russian Federation and subsequent disruption to regional export routes has had major spillover effects, including oil and gas exports. Inflation remained high due to expansionary fiscal policy and rising global food prices. The outlook is for further growth at a more moderate pace in 2009–2010 and for inflation to remain elevated. In a longer-term perspective, the Government has substantially improved trade and investment conditions in an effort to spur private sector development, particularly in the non-oil segment.

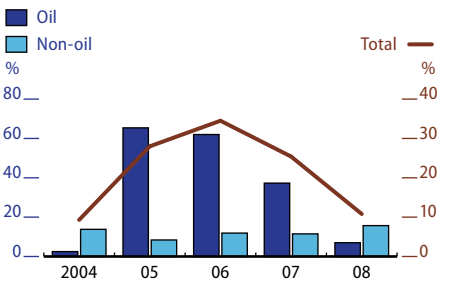
Economic performance

For the fourth consecutive year in 2008 and despite slowing from an average of 29.3% in 2005–2007, Azerbaijan's economy was among the fastest-growing in the world, with GDP growth estimated at 10.8% (Figure 3.2.1). Net exports, fueled by substantial new oil and gas production, remained the major driver of growth. The conflict between Georgia and the Russian Federation in August was a shock to the economy however, because transport and trade routes, including those for oil and gas, transit Georgia. Although export of hydrocarbons from the Caspian Sea was restored in late September, oil production in 2008 increased by just 6% compared with an earlier-projected 26%. Investment also remained an important contributor to growth, even though its share in GDP fell by around 3 percentage points to about 19% of GDP in 2008. Foreign direct investment, particularly in hydrocarbons and the public sector, remained significant, albeit reduced.

On the production side, growth was led by construction, services, and agriculture. Construction expanded by 36%, reflecting increases in secondary-town and rural infrastructure, in residential buildings and office centers across the country, and in transport facilities. Services rose by 13.7%, underpinned by expansion in transport (13.5%) and communications (28.2%), with reforms driving telecommunications. Trade and transit activities grew with reforms in customs procedures. With good weather and considerable support from the authorities, agriculture improved its weak performance in 2006–2007 to expand by about 7%, with a substantial surge in wheat, fruits, and vegetables. Non-oil GDP grew at almost 16%, the highest rate in 5 years.

Consumer price inflation accelerated to an average of 20.8% from 16.7% in 2007. The increase reflected steeper prices of food mainly, which has a weight of over 30% in the consumer basket. Higher import prices (including food), rapid monetary expansion, and a near doubling of civil service salaries and social security payments also fueled the

3.2.1 GDP growth by sector



Sources: International Monetary Fund, Country Report No. 08/216, available: http://www.imf.org/external/country/AZE/index.htm; *Asian Development Outlook* database; staff estimates.

Click here for figure data

This chapter was written by Rafael Abbasov of the Azerbaijan Resident Mission, ADB, Baku.

rise. Until midyear, the country experienced a sharp increase in the price of imported wheat, the main staple. The authorities responded by introducing tax holidays both for importers and for local wheat producers, by setting agricultural production targets, and by providing subsidies to farmers and agricultural businesses. With rail networks via Georgia damaged by the conflict, trade disruptions lifted consumer prices in Azerbaijan, because of the country's heavy reliance on imported foodstuffs and consumer goods. End-year inflation, however, moderated to 15.3%, mainly due to easing imported food prices (Figure 3.2.2).

Price stability is the stated monetary policy objective of the National Bank of Azerbaijan (NBA), the central bank. However, NBA is constrained by the fiscal dominance of monetary policy, given that double-digit growth in public expenditure is made possible by the Government's use of its very rapidly growing oil and gas revenues. The large oil-related foreign currency inflows have created pressures for rapid growth in monetary aggregates. NBA has raised its purchases of foreign exchange to limit nominal appreciation of the manat. Broad money (M3) was up by 44.0% in 2008, though much less than the 71.4% expansion recorded in 2007 (Figure 3.2.3). The manat appreciated by about 4.5% in nominal terms against the United States dollar.

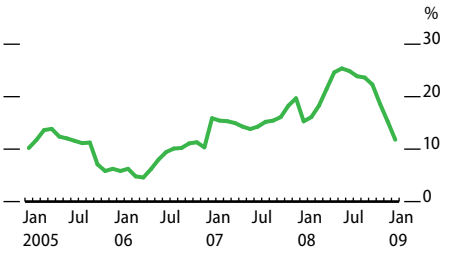
Increases in monetary aggregates also reflect commercial banks' foreign borrowing, which has fueled a rapid expansion in their lending. However, since the global financial crisis intensified in September 2008, banks' access to international capital markets has been hit. Credit to the economy rose by 55.6% in 2008, much of it going to households and small businesses.

Most local banks were affected by the global credit crunch and liquidity squeeze, and some of them virtually stopped lending. After October 2008, NBA relaxed monetary policy substantially, reducing the refinancing rate several times from 15% to 8% in December. It also halved its reserve requirement for banks from 12% to 6%, and canceled the 5% reserve requirement on domestic banks' foreign liabilities. NBA, as lender of last resort, announced an emergency facility for liquidity support for commercial banks. Also, to help ensure sustainability of the banking system, NBA tightened provisioning ratios and raised collateral requirements for loans from 120% to 150%. In addition, the Government introduced special tax waivers to encourage increased capitalization of banks and insurance companies.

The central bank in March 2008 introduced a new exchange rate arrangement that pegs the manat to a dollar–euro currency basket. This was an important measure intended to limit imported inflation and, as a step toward greater exchange rate flexibility, introduced two-sided exchange risk to the market. Given the significant changes in the dollar–euro rate during the year, the basket arrangement would have led to a sizable depreciation of the manat against the dollar, and was therefore temporarily suspended. During 2008, the manat appreciated by 4.2% against the dollar, but the real effective exchange rate appreciated by 12.9% because of Azerbaijan's higher inflation (Figure 3.2.4).

As in recent years, the Government ran an expansionary fiscal policy, induced by soaring oil revenue. With midyear budget revisions (an increase in revenue and expenditure of 41.8% and 29.8%), consolidated

3.2.2 Inflation



Source: State Statistical Committee of the Republic of Azerbaijan.

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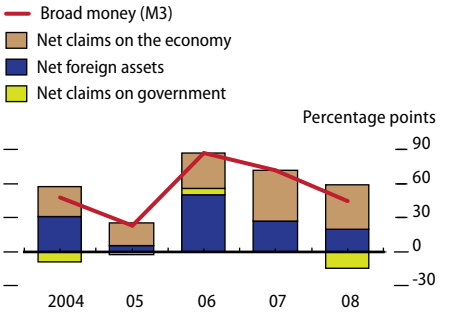
3.2.3 Factors affecting money supply (M3) growth



Source: National Bank of Azerbaijan, available: http://www.nba.az, downloaded 5 March 2009.

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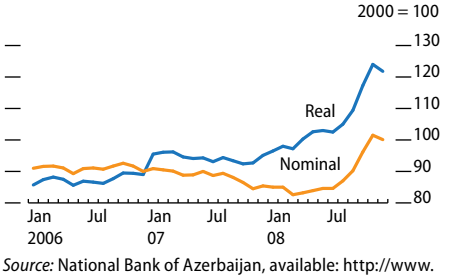
3.2.4 Effective exchange rates



Source: National Bank of Azerbaijan, available: http://www.nba.az, downloaded 5 March 2009.

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expenditure jumped by 82.5%. The budget expansion was enabled by a steep rise in direct transfers from the State Oil Fund (SOFAZ). Government receipts were also boosted by the sale of state shares in the largest mobile operator and the smaller of the country's two state-owned banks.

On the expenditure side, capital spending (energy, irrigation, transport, and utilities) rose, as did recurrent spending, mainly because of increased salaries and social security payments. Defense remained the single largest expenditure category, accounting for 12.2% of total spending. The spending surge in 2008 pushed the state budget into deficit and stoked inflation pressures (Figure 3.2.5).

A substantial part of the Government's oil revenue was channeled to SOFAZ, the assets of which climbed by over 50% and stood at $11.2 billion at end-2008. Accumulating part of oil revenue in SOFAZ helps reduce upward pressure on the exchange rate, reducing the potentially destabilizing effect of large foreign inflows. Part of the budget revenue from high oil prices has been saved in a special treasury account.

As in previous years, hydrocarbon flows dominated the balance of payments. The rise in oil production and exports and relatively high oil prices until midyear helped generate a current account surplus at year-end of an estimated $22 billion, equivalent to 47.7% of 2008 GDP (Figure 3.2.6). The near doubling of the trade surplus (95.9%) was boosted by a surge in crude oil and gas exports, which together accounted for over 96% of exports. (Growth of non-oil exports rebounded on a recovery in petrochemical, metallurgical, and aluminum production.)

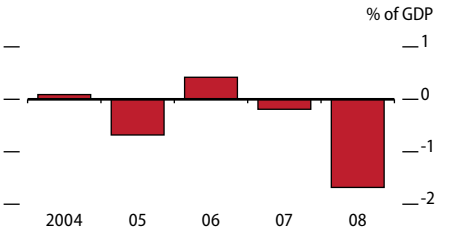
With the completion of major oil and gas exploration projects, the share of hydrocarbons in imports fell. However, overall import growth at 19.4% was driven mainly by increased public spending for infrastructure refurbishment, which required substantial imports of machinery and equipment. Gross international reserves, excluding SOFAZ assets, are estimated to have leaped from $4.3 billion in 2007 to about $6.5 billion at end-2008 (Figure 3.2.7). The overall public and publicly guaranteed debt burden was low, at less than 10% of GDP, reflecting the Government's conservative external borrowing policy.

According to the World Bank's *Doing Business 2009* report, Azerbaijan was one of the world's top reformers in streamlining business regulations, and improved in seven out of 10 areas, including introduction of a one-stop shop for business start-up, introduction of a unified property registry, and greater protection for minority shareholders. The tax authorities have also initiated substantial improvements of the department for large taxpayers, which is responsible for overseeing about 700 enterprises that provide over 90% of tax revenue. Progress in introducing an electronic tax payment and filing system was also made, which benefits medium-sized companies in particular.

Economic prospects

Prospects are closely linked to oil prices. GDP growth is projected to fall to 8.0% and then to 6.7% over the forecast period, reflecting relatively modest expansion in the hydrocarbon sector and slowing growth in crude oil and natural gas exports. With foreign investments in the oil sector

3.2.5 Budget balance



Source: National Bank of Azerbaijan, available: http://www.nba.az, downloaded 5 March 2009.

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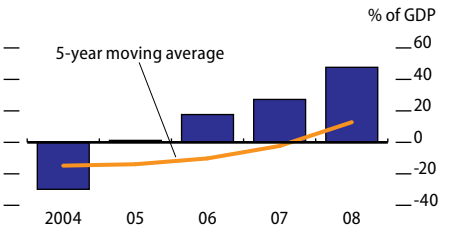
3.2.6 Current account balance



Sources: International Monetary Fund, *Country Report* No. 08/216, available: http://www.imf.org/external/country/AZE/index.htm, downloaded 5 March 2009; staff estimates.

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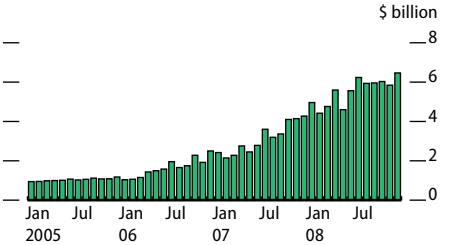
3.2.7 Gross international reserves



Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 5 March 2009.

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declining, public investment will become the single largest source of GDP growth, accounting for about 60% of total investments. The expected expansion in the non-oil sector at 5–7% will come largely from services, especially transport.

The authorities recognize the uncertainties in global oil markets when making state budget revenue projections for 2009; their price assumption of $70/barrel for 2009 would seem optimistic. Public spending growth is set to slow markedly to around 15% versus an average of 65% in the past 3 years. Lower oil prices will particularly affect revenue from corporate profit taxes, and slowing consumer spending and imports will weaken receipts from the value-added tax. Direct budget transfers from SOFAZ are budgeted to grow by 29.3% this year and account for about 40% of total state budget revenue. Continued substantial reliance on SOFAZ could lead to early depletion of its assets, which would of course jeopardize its savings function for future generations. The budget envisages a deficit of only 0.4% of GDP, though this is unlikely to be achieved.

Although the Government is keen to reduce fiscal spending in the medium term, in the 2009 budget it intends to lift capital investment moderately (including roads, and water supply and sanitation in secondary towns) and restructure expenditure in the social sector (it has pledged a 25% increase, mainly in health and education).

In late 2008, the authorities unveiled draft revisions to the tax code, including cuts in the profit tax (of 2 percentage points) and value-added tax (of 1 point). This is part of a stimulus package for developing the private sector, in particular non-oil industries, as part of the wider aim of strengthening national competitiveness.

Inflation is expected to moderate substantially to 12.0% in 2009 and to 7.0% in 2010, reflecting the substantial slowdown in government expenditure and tighter monetary policy. Some upward pressures on prices, however, will remain from budgeted increases in public salaries and social security payments.

Largely on lower oil prices, the current account surplus is expected to decline to 25.5% and 17.7% in 2009 and 2010. Exports are likely to fall by some two thirds in 2009, owing to sharply lower values (despite increased output) of hydrocarbons. The export of non-oil commodities (primarily agricultural products and metals) is forecast to grow strongly. Import growth is projected to slip, reflecting a slowdown in economic activity and a moderation of public investment growth.

3.4.1 Selected economic indicators (%)

	2009	2010
GDP growth	8.0	6.7
Inflation	12.0	7.0
Current account balance (share of GDP)	25.5	17.7

Source: Staff estimates.

Georgia

After several years of strong growth underpinned by surging foreign capital inflows, Georgia was hit by the double shocks of an armed conflict with the Russian Federation and the global financial crisis. The authorities' response was swift and appropriate—fiscal and monetary easing complemented with financial sector regulatory forbearance to stimulate demand. In the near term, higher public investment supported by a significant step-up in official development assistance is expected to put the economy back on the path to recovery. However, the vulnerabilities that have been exposed by the shocks could, unless addressed, have longer-term effects. Structural policy drivers need to be effectively implemented to strengthen domestic resource mobilization and so increase resilience to shocks and the capacity to manage risks.

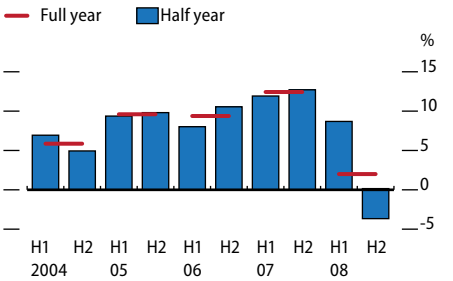
Economic performance

From 2005 through the first 7 months of 2008, Georgia experienced a period of sustained strong growth that was underpinned by surging capital inflows. The economy was then hit by the twin shocks of the conflict with the Russian Federation in August and the global financial crisis in September. With the sudden deceleration in capital inflows and the onset of a credit drought, the economy contracted in the second half of the year (Figure 3.3.1). GDP growth for the full year (2.0%) is the weakest outcome since 2000.

On the demand side, the most significant impact of the shocks was a sharp slowdown in domestic demand. With the reversal of investor sentiment, a rise in risk premiums, and deferral of some large privatization-related foreign direct investment (FDI) transactions, FDI inflows—the engine that had powered the domestic demand boom during 2005–2007 and that had accounted for over 60% of gross fixed capital formation in 2007—faltered. In addition, commercial banks had become dependent on external borrowing to finance rapid domestic credit expansion. When they lost access to international capital markets, domestic banks faced a liquidity crisis and stopped lending. Consequently, the contribution of investment to growth contracted.

Negative feedback loops between the financial and real sectors triggered by the conflict intensified in September when the global financial crisis worsened. Risk premiums rose well above levels reached at the peak of the August conflict, damping prospects for Georgia's early resumption of access to international capital markets and recovery of private FDI inflows. Consumer confidence fell at the same time as the conflict and the financial crisis heightened uncertainty, access to consumer credit became more constrained, the ending of the real estate boom set off a negative wealth effect, and remittance inflows (mainly from the Russian Federation) slowed. Net exports of goods and services

3.3.1 GDP growth



Sources: State Department for Statistics of Georgia, available: http://www.statistics.ge, downloaded 24 February 2009; staff estimates.

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This chapter was written by Padmini Desikachar of the Central and West Asia Department, ADB, Manila.

subtracted more from GDP growth than in 2007 as the surplus on the services account contracted because of the fall in tourism earnings.

On the supply side, agriculture shrank in the third quarter of 2008, when farmers in the conflict areas were displaced and irrigation supplies were disrupted. In industry, the finance-sensitive construction subsector underwent a sharp contraction in output after several years of double-digit growth. Manufacturing subsector growth was also hit as demand slumped and credit became tight.

While services overall recorded growth, some conflict-affected subsectors contracted, particularly transport and tourism-related activities. Financial services, among the fastest-growing subsectors in 2007, suffered from the double impacts of the conflict and the global financial turmoil. The unemployment rate, already high at 13.3% in 2007, is expected to rise further due to the economic downturn and a significant increase in the number of internally displaced persons in the wake of the August conflict. In turn, the rise in unemployment is expected to affect poverty incidence, which stood at 23.6% in 2007.

The recent high growth period (2005–2007) was associated with large current account deficits, even larger capital account surpluses, overall balance-of-payments surpluses, and steady reserves accumulation. In 2008, however, the overall balance-of-payments position moved into a deficit because the current account deficit dominated the capital account surplus (Figures 3.3.2 and 3.3.3). Before the double shocks, the widening current account deficit was seen as a natural consequence both of the country's rapid economic growth and of the increasing reliance on capital goods and energy imports. However, the large deficit that had seemed sustainable in a period of surging capital inflows suddenly looked unsustainable in a context of steeply falling capital inflows.

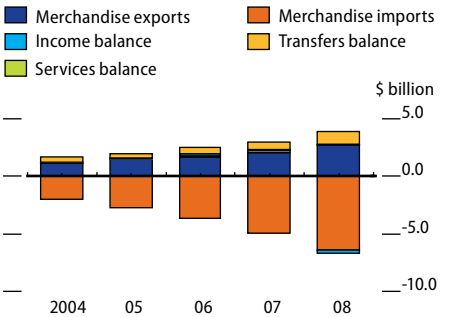
Current account developments in Georgia have been dominated by trends in imports. With the country's dependence on food and energy imports and high world prices in 2006 through the second half of 2008, the import bill rose by 20% in 2008 compared with 2007. Merchandise exports performed well in the first 3 quarters of 2008 but weakened in the last because of the global downturn. Export revenues of copper and others metals—among the country's top exports—were affected by the retreat in global demand and prices.

The services account balance deteriorated as tourism revenue collapsed following the conflict, marking a shift from the trend of rising services account surpluses. The income account also worsened, swinging to a deficit. The fall in wages of Georgia's cross-border seasonal workers was a factor. The enlarged surplus on the current transfers account in 2008 came from the sharp increase in official transfers, reflecting significant emergency assistance from donors.

In the capital and financial account, net FDI was estimated to be lower by $416 million and the net outflow of currencies and deposits higher than in 2007. The account reflected support from international financial institutions to the banking sector in the form of portfolio equity and debt finance. The shifting private–public composition of capital flows is reflected in the capital account, with a pickup in external government borrowing.

With excess demand for foreign exchange reflecting a changing balance between the current and capital accounts, protection of reserves

3.3.2 Current account components



Source: National Bank of Georgia, available: http://www.nbg.gov.ge, downloaded 18 February 2009.

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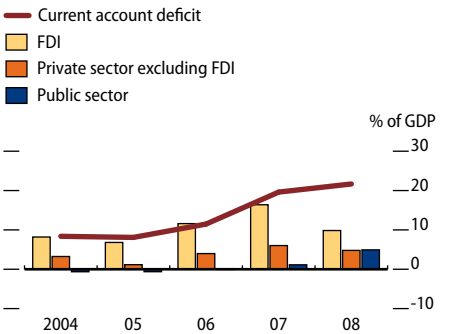
3.3.3 Capital flows and current account deficit



Source: International Monetary Fund, *Country Report* Nos. 07/107 and 09/1, available: http://www.imf.org/external/country/GEO/index.htm.

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has now become a concern. From 2006 through the first half of 2008, strong capital inflows helped accelerate reserves accumulation. When the conflict broke out, confidence in the local currency (the lari) was hit, and withdrawals of deposits and replacement of the lari by the United States (US) dollar surged, leading to exchange rate pressures. Reserves losses followed, as the National Bank of Georgia (NBG), the central bank, intervened immediately to defend the currency, introducing a temporary exchange-rate peg. A standby arrangement reached with the International Monetary Fund in September helped replenish reserves.

As the global financial crisis worsened, however, the lari again came under pressure. NBG opted for a steep depreciation in November and intervened to stabilize the exchange rate at around its perceived new equilibrium of GEL1.65/$1. At end-2008, international reserves were $119 million higher than at end-2007 (Figure 3.3.4), a level that included transfer of resources from the recently established sovereign wealth fund to international reserves and a partial drawdown on the standby arrangement.

The private sector accounts for most of Georgia's negative saving–investment gap. The investment rate peaked in 2007, supported by pickups in both private and public investment, before falling by over 2.5 percentage points of GDP in 2008 owing to the slowdown in private capital inflows. The savings rate fell by 14.8 percentage points in 2004–2008, pulled down by a steep decline in private saving (Figure 3.3.5).

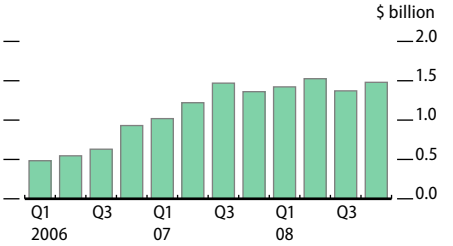
Private saving tumbled because credit growth to households and the corporate sector had accelerated after 2006 while deposit growth had lagged. Commercial banks had met the widening resource gap (credit less deposits) by borrowing from abroad to fund their domestic lending, until their access to international capital markets was closed in the second half of 2008. Given the now less favorable environment for FDI inflows, Georgia's low private savings rate could become the binding constraint to the higher investment needed to sustain strong growth.

Inflation was on the rise during the first 3 quarters of 2008 due to demand pressures and rising import prices, but it fell back in the last quarter (Figure 3.3.6). Indications of demand pressures included the outpacing of productivity growth by real wage growth, expansionary fiscal policies, strong broad money growth, and rapid credit expansion, though NBG's policy of allowing the nominal exchange rate to adjust helped ease pressures a little.

In the first half of 2008, import prices, led by food and fuel, rose sharply due to high inflation in Georgia's leading trading partners (Azerbaijan, Kazakhstan, Russian Federation, and Ukraine). There was also significant acceleration in selected nontradables inflation, particularly services. The sharp inflation spike in August triggered by the conflict dissipated and the economy entered a phase of disinflation. In addition to sluggish demand, contributory factors were falling commodity prices, deceleration in monetary aggregates, and credit contraction.

During the surge of capital inflows in January–July 2008, the nominal effective exchange rate (NEER) appreciated by 10.3% (Figure 3.3.7). The appreciation of the real effective exchange rate (REER) was more muted, because Georgia experienced slower inflation than its major trading partners. When the lari was temporarily pegged to the dollar in August–

3.3.4 Gross international reserves



Source: International Monetary Fund, *International Finance Statistics* online database, downloaded 24 February 2009.

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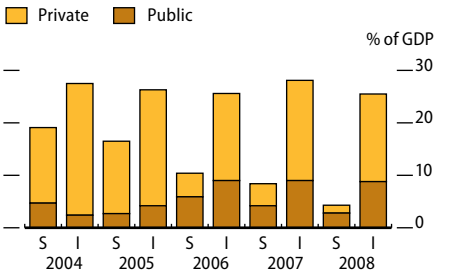
3.3.5 Saving and investment rates



I = investment; S = saving.

Source: International Monetary Fund, *Country Report* Nos. 07/107 and 09/1, available: http://www.imf.org/external/country/GEO/index.htm.

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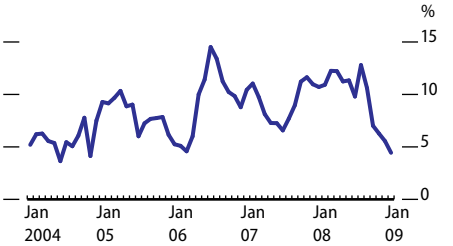
3.3.6 Inflation



Source: National Bank of Georgia, available: http://www.nbg.gov.ge, downloaded 24 February 2009.

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October, the NEER and REER continued to appreciate due to exogenous changes in the dollar relative to other trading partner currencies. Subsequently, however, the NEER and REER pulled back, reflecting the central bank's decision to allow a one-time large depreciation vis-à-vis the dollar in early November when the lari came under renewed pressure; broad-based strengthening of the dollar; and further moderation in inflation pressures.

Broad money (M3) growth was only 6.9% for full-year 2008, falling sharply in August (Figure 3.3.8). Two factors pulled it down. The first was a decline in net foreign assets of both NBG and the commercial banks at a time when capital inflows slowed, outflows to pay import bills increased, and reserves were drawn down to defend the currency and to shore up banking system liquidity. The second was a marked slowdown in the expansion of net domestic assets as banks scaled back lending to the private sector. In the wake of the conflict, banking system deposits contracted at end-September, but recovered partially. Currency held by the public also fell in August, reflecting substitution from local to foreign currency in the uncertain environment, and remained low at year-end.

From 2004 through the first half of 2008, the three key drivers of tax revenue–simple and transparent tax policy, efficient and corruption-free tax administration, and booming economic activity–propelled revenue collections to new heights and helped create the fiscal space for growth-oriented public spending. In January 2008, the authorities set up a sovereign wealth fund to save resources generated by the revenue overperformance.

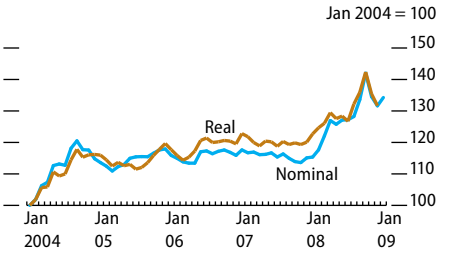
The August conflict dealt a setback to public finances, with the economic downturn leading to revenue shortfalls compared with precrisis targets, particularly in value-added tax revenues. At the same time, postconflict infrastructure reconstruction, as well as increased spending on internally displaced persons and on social assistance, put public finances under stress. On the financing side, privatization receipts that had hitherto more than covered the deficit contracted, leaving the authorities to face a potential budget gap.

A fiscal and monetary domestic policy stimulus was designed to support an early recovery. The authorities, in the context of manageable public debt, opted for a countercyclical fiscal stance with an emphasis on expenditure measures that were underwritten by significant official development assistance: investment projects were frontloaded, targeted cash transfers were disbursed quickly to families suffering conflict-related casualties and to internally displaced persons, and the social assistance system was expanded to include the greater number of economically vulnerable people.

Consequently, capital spending picked up sharply in the fourth quarter of 2008 as did subsidies and social spending. At year-end, expenditure was higher than both the revised (October 2008) postcrisis budget figure and the precrisis target. The consolidated (general) budget deficit widened to 5.7% of GDP (8.4% excluding grants) in 2008 compared with 4.7% in 2007 (Figure 3.3.9). The deficit was financed mainly through external borrowing on concessional terms.

Georgia's ratio of public debt to GDP remains moderate. In the last few years, declining external public debt has been partly offset by rising

3.3.7 Effective exchange rates



Source: National Bank of Georgia, available: http://www.nbg.gov.ge, downloaded 24 February 2009.

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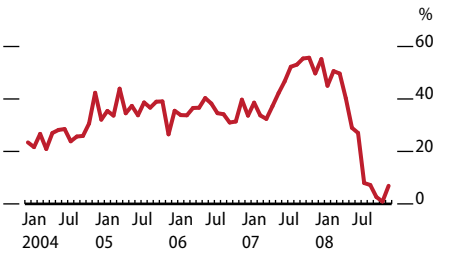
3.3.8 Money supply (M3) growth



Source: National Bank of Georgia, available: http://www.nbg.gov.ge, downloaded 24 February 2009.

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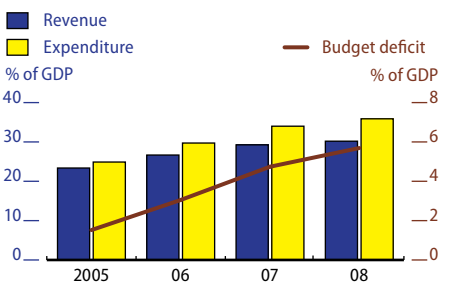
3.3.9 Fiscal indicators



Source: International Monetary Fund, *Country Report* Nos. 07/107 and 09/1, available: http://www.imf.org/external/country/GEO/index.htm.

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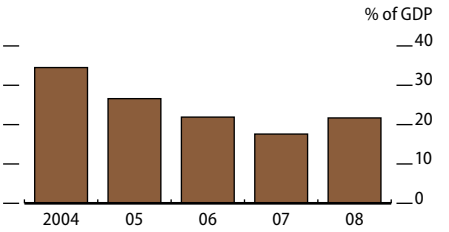
private sector borrowing, mainly by commercial banks (10.2% of GDP in 2007) and to a lesser extent by the corporate sector (2.4%). Following the conflict, higher external public borrowing is replacing private sector borrowing. Still, public debt remains manageable: the external public debt-to-GDP ratio stands at 21.7% (Figure 3.3.10) and the debt service ratio on external public debt is a low 3.3%.

NBG's focus shifted from tightening monetary policy (to contain inflation pressures) in the first half of 2008 to deploying monetary instruments (as part of the macroeconomic stimulus package) in the second. To provide needed liquidity, reserve requirements were temporarily waived and then reintroduced at a significantly lower rate than the precrisis requirements (Box 3.3.1). The central bank had raised the policy rate to 12% in April 2008 and then cut it after late August—it stood at 8% at year-end. However, the desired response from banks, namely extension of credit to the private sector on affordable terms, was disappointing.

3.3.10 External debt



Source: International Monetary Fund, *Country Report* Nos. 06/171, 07/107 and 09/1, available: http://www.imf.org/external/country/GEO/index.htm.

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Economic prospects

The external environment will remain challenging in the near term. It is likely that the global financial crisis will continue through 2009 with international credit channels for Georgia remaining constrained. Growth in the country's trading partners will slow further this year but some recovery is expected next year. Commodity prices, including food, fuel, and metals, will remain subdued over the forecast period. The authorities are expected to pursue fiscal and monetary policies aimed at economic recovery, with the continued support of the international donor community. They are also likely to deepen structural reforms so as to improve resilience to shocks. It is expected that further regional conflict will be avoided, although heightened tensions with the Russian Federation will persist.

GDP growth in 2009 is now projected at 2.5%, lower than the 4.0% forecast by the authorities in October 2008. Recovery is expected to gather pace in 2010. The key supporting factors will be stepped-up public investment spending, a modest recovery in consumption growth, and a smaller negative contribution of net exports.

Public investment that is focused on infrastructure projects is expected both to have multiplier effects (in the short run) and to boost demand. A cut in the personal income tax, effective 1 January 2009, and an increase in social benefits are also expected to strengthen consumption growth. New tax incentives for private investment may, however, have less traction because businesses are likely to remain cautious about raising investment when their profit expectations are uncertain. Moreover, the continuing credit crunch will affect private investment in credit-dependent activities. The negative contribution of net exports to GDP growth is expected to narrow as imports contract and as services exports recover a little.

On the production side in 2009, manufacturing enterprises and the services sector, both facing subdued demand, are expected to see only moderate growth. Infrastructure is expected to recover though, supported by increased public investment. The recovery of GDP growth is

3.3.1 Selected economic indicators (%)

	2009	2010
GDP growth	2.5	6.0
Inflation	7.0	7.5
Current account balance (share of GDP)	-18.8	-20.0

Source: Staff estimates.

3.3.1 Banking sector stress

Prior to the conflict with the Russian Federation in August 2008, the sharp increase in credit growth was financed by banks' external borrowing. A large portion of their lending was channeled toward real estate and consumers. As in other countries, surging capital inflows into the banking system caused credit to grow too rapidly, and loan quality suffered. With hindsight, they also made the values of the banks' portfolios vulnerable to volatility in economic activity, not least a major shock to the economy.

The impact of the conflict exposed these latent vulnerabilities, which were manifested in the sudden shrinkage in bank lending capacity. This contraction stemmed from the rise in country risk following the conflict, which was exacerbated by the global financial crisis; from conflict-related deposit withdrawals, some of which remained outside the banking system and which also negatively impacted the lending base; and from the need for higher loan-loss provisioning in the expectation that nonperforming loans would go up as bank debtors found it increasingly difficult to service their debt—further cutting into bank lending capacity.

Beyond the rise in risk premiums, Georgian banks also faced the problem of rolling over the debt maturing in early 2009. They became unwilling to lend because of heightened perceptions of credit risk, resulting in a flight to quality. Moreover, against the backdrop of a slowdown in economic activity leading to business failures, a downward spiral of deleveraging and economic slowdown was a risk.

The authorities responded quickly to address financial stress during and following the August conflict. To ease the liquidity squeeze faced by banks, the National Bank of Georgia, in coordination with the recently established (May 2008) Financial Supervisory Agency, adopted a countercyclical regulatory response, including temporarily waiving reserve requirements in August, reintroducing them at a lower rate in September, reducing liquidity ratio requirements, introducing a special bridge-financing facility using penalty rates, and launching a refinancing window to serve as the new benchmark policy rate (which it subsequently cut several times).

With a view to reducing risks stemming from deleveraging, the European Bank for Reconstruction and Development and the International Finance Corporation made available equity and debt financing for selected banks.

The authorities have achieved their immediate objective of restoring depositor confidence and stabilizing the banking system. The longer-term concern is that, although the central bank has increased liquidity, banks remain reluctant to lend. The monetary policy transmission mechanism, particularly the credit and interest rate channels, had been quite weak even before the global financial crisis. The transmission mechanism is likely to be even less effective now, with both credit demand and lending insensitive to policy rate changes.

expected to gather pace in 2010 as global conditions improve, stimulating a recovery in FDI inflows and private investment. Public investment in infrastructure will stay significant in 2010. Net exports are expected to subtract more from GDP growth in 2010 than in 2009, as import growth associated with the recovery of FDI inflows accelerates, outpacing the pickup in export growth.

The economy is projected to have large external financing requirements in the forecast period, which are likely to be met through public sector borrowing, FDI, and private sector borrowing. A downside risk to the growth outlook is that there may be shortfalls in public and private capital inflows that could affect the investment recovery. With their own economies weakening, foreign governments may scale back their development assistance. Also, if the global financial crisis lasts longer than expected, private capital flows to Georgia will remain constrained.

With domestic demand moderately higher in the first half of 2009 than the previous half-year, easy monetary conditions, and the effect of depreciation in the REER on domestic production costs, the disinflation trend that emerged in the fourth quarter of 2008 is likely to reverse. Annual average inflation in 2009 is projected at 7.0%, but this projection is subject to uncertainty, mainly due to potential volatility in the

exchange rate. In 2010, as economic recovery gathers pace and credit availability gradually expands, inflation is forecast to pick up to 7.5%. The inflation-targeting regime that the authorities have committed to phasing in will, over time, help anchor inflation expectations.

The current account position is likely to improve over the forecast period. The deficit is likely to narrow this year, reflecting flat import volumes and lower world oil prices that will bring down the oil import bill. Exchange rate depreciation is likely to discourage growth in consumer imports. The slowdown in trading partners is seen keeping exports subdued in 2009, neutralizing the potential boost from a lower exchange rate. In particular, lower world demand for key commodity exports, such as copper and other metals, will damp export earnings.

The current account deficit is expected to widen in 2010, as import growth picks up again, reflecting economic recovery and strengthening FDI inflows. Export volumes are also expected to move higher on a recovery in external demand, and as structural reforms help in attracting investment into export activities, improving productivity, and creating an enabling environment for export diversification. With the recovery of global growth, services exports, including tourism receipts, are expected to grow strongly. Downside risks to the external outlook include any worsening of regional tensions, which could affect services exports and remittance inflows, and higher world oil prices, which would be reflected in a larger trade deficit.

Structural reforms will be key both to further strengthening Georgia's resilience to shocks and to sustaining growth. Product and factor market reforms have helped in factor reallocation, new business entry, and higher productivity. As a result, the economy was in a position to withstand the moderate shock of the Russian trade and transit embargo imposed in 2006.

Since then, Georgia has continued to make efforts to improve the business regulatory environment. On the World Bank's *Doing Business 2009* survey, it improved its global ranking to 15, registering positive reforms in several dimensions: starting a business, registering property, protecting investors, and paying taxes. While these reforms have cemented the country's reputation as an investor-friendly destination, the severe effects of the twin shocks of 2008 have highlighted the unfinished structural reform agenda.

The authorities need, for example, to develop strategies for risk sharing that could include projects' design and financial structuring, particularly in priority infrastructure areas such as transport and energy. Focusing on regional investors such as Turkey and Azerbaijan may also be fruitful because, given regional interlinkages, they would have an important stake in Georgia's speedy economic recovery.

Measures to support local businesses that will also facilitate economic recovery and create jobs include improving small and medium-sized enterprises' access to capital through broadening the types of collateral that banks can accept; reducing costs associated with evaluation of credit information; and establishing effective systems for enforcing repayment, strengthening property rights protection, and reducing the costs faced by firms in using the courts.

3.3.2 Development challenges

The challenge that Georgia faces over the medium to long term is to strengthen policies and institutions that will generate a virtuous cycle of growth, investment, and saving. Recent events have underscored the risks of a downward spiral triggered by the unexpected drying-up of capital inflows.

To recover and sustain high growth, a more balanced mix of foreign and domestic resources for financing investment will be needed. The authorities envisage regaining lost ground by channeling development assistance (which is filling the gap left by private capital inflows) toward growth-oriented public infrastructure investment.

In addition to receiving budget support, the Government is proposing to set up a multidonor trust fund—the Phoenix Fund—to attract debt and equity financing for large infrastructure projects. Such large investments would in time be likely to crowd in private investment.

While external sources will continue to play an important role, it is crucial to raise domestic private saving and investment. To this end, well-designed financial and fiscal instruments will be needed to create an enabling environment for efficient domestic resource mobilization.

Kazakhstan

After nearly a decade of rapid expansion, economic growth plummeted in 2008 under the weight of the global financial crisis and economic slowdown. Limited access to international capital markets virtually halted domestic lending, triggering a slump in real estate. The fall in global oil and metal prices cut into the current account surplus by year-end. The authorities responded to the shocks by shoring up banks' capital, adopting financial policies to sustain growth, and adjusting the exchange rate. Although the short-term outlook is for slow growth in difficult conditions, long-term prospects are highly positive, given the country's large stock of official foreign assets, oil and metal wealth, and record of sound economic management.

The global financial crisis and economic slowdown have hit Kazakhstan hard. Since the start of the turmoil in mid-2007, international capital markets have pulled back sharply on their lending to Kazakh commercial banks, and this in turn virtually halted their lending activity. It was largely their lending in previous years that had spurred rapid growth in the country's non-oil sector (the bulk of the economy).

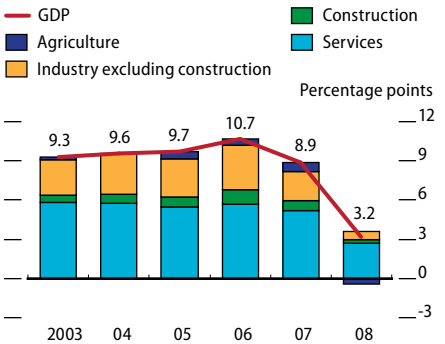
The sharp weakening in global oil prices in the second half of 2008 appears to have had little direct impact on full-year growth, though it crimped the current account surplus. Looking ahead, however, the expectation of low oil prices for some time has weakened investor and consumer confidence, and will reduce the Government's revenue and its fiscal space for reviving the economy.

GDP growth in 2008 drooped to 3.2% (Figure 3.4.1), from the 8.9% of a year earlier when growth had already been undermined in a weak fourth quarter. Output growth in 2008 fell below the previous year's in all subsectors, except mining (up 5.3%), oil (up 4.9%), and natural gas (up 14.4%). Despite good performance in these extractive subindustries, growth in industry fell to 2.4% owing to a 2.6% drop in manufacturing output as consumer and investment spending declined. Expansion in construction, a strong sector in recent years, tumbled to 1.9% from 16.4% in 2007 as the boom in real estate, which had been fueled by several years' rapid expansion in bank lending, collapsed.

In the large services sector (accounting for just over half of GDP) growth slowed from 9.4% in 2007 to 5.0%, reflecting adjustment in consumer spending as well as a 0.5% drop in financial services output. Growth in the relatively small agriculture sector (about 7% of GDP) fell by 5.6%, from 8.9% a year earlier, due to a severe drought and the high base effect of 2007.

Statistical indicators suggest that growth in private consumption, import volume, and fixed investment (outside the oil sector) decelerated

3.4.1 Contributions to growth (supply)



Source: Agency of Statistics of the Republic of Kazakhstan.

Click here for figure data

This chapter was written by Kiyoshi Taniguchi of the Uzbekistan Resident Mission, ADB, Tashkent and Asset Nussupov, consultant.

sharply. Public consumption and exports appear to have risen at about the same pace as in recent years.

Consumer price inflation moved into double digits in September 2007 and stayed high through August 2008, when year-on-year inflation hit a peak of 20.1%. However, price rises moderated quickly to 9.5% by December and continued to ease in the early months of 2009 (Figure 3.4.2). The escalation and subsequent easing of food prices was the dominant factor in overall inflation and they closely reflected global food price developments. The Government undertook several administrative measures to limit increases in food prices, though drought and a drop in agricultural output somewhat offset these efforts.

Slower growth in consumer spending appears to have had an impact on nonfood and services prices and, as the economy continues to slow, will likely further reduce inflation. Year-average inflation reached 17.3% in 2008, up from 10.8% the previous year.

Substantial foreign borrowing allowed domestic banks to rapidly expand their domestic lending, which, in the third quarter of 2007, was 5.5 times as high as in 2004. With such funding no longer available, loans to the private sector flatlined, growing by about 3% in 2008 (Figure 3.4.3). Since much bank lending was for mortgages or property development and about 40% of bank credit is secured on real estate, the stability of the banking system depends on the strength of the property market. With lending at a standstill, developers cannot continue construction projects, which now stand unfinished, and buyers cannot get mortgages. Property prices sank in 2008 with prices for new housing falling by 20.5% and for existing homes by 8.5% (Figure 3.4.4). The share of nonperforming loans at end-2008 had moved up to 9.0% in January 2009, from 5.1% in mid-2008.

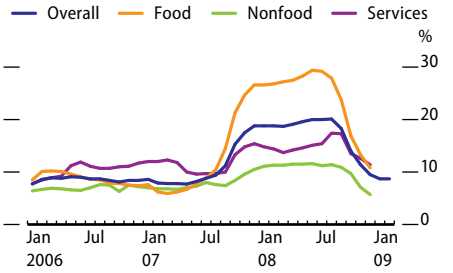
Banks met their foreign debt repayment obligations in 2008, reducing balance sheet foreign liabilities by T816 billion (about $7 billion) during the year. The authorities put in place, in late 2008, plans to shore up the banks by injecting government capital and by creating a distressed asset fund, and some of this funding was disbursed.

In early February 2009, however, the Government was forced to take control of the largest and fourth-largest banks, and provided capital assistance to the second- and third-ranked banks. The four banks together account for about two thirds of banking system assets. The Government took this step in response to concerns that banks would find it difficult to make $11 billion of foreign debt repayments due in 2009. This action should reassure creditors.

Samruk-Kazyna, the government holding company for state-owned assets that also provides development finance, is furnishing resources to recapitalize banks, establish a distressed-asset fund, and set up a real-estate-support fund. The Government's $17 billion stimulus package, announced in November 2008, included initiatives for developing small and medium-sized enterprises, supporting industrial and infrastructure projects, and developing agriculture further.

The current account balance in 2008 posted a surplus of $8.9 billion or 6.7% of GDP in 2008 (Figure 3.4.5). This was a marked improvement from a $7.3 billion deficit a year earlier, and was mainly due, on the one hand, to much higher revenue from oil and metal exports that was

3.4.2 Inflation



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 9 March 2009.

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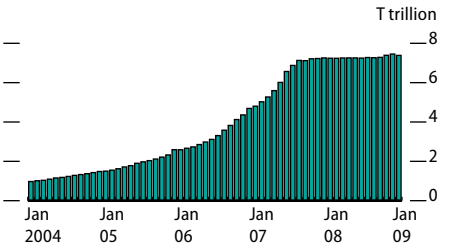
3.4.3 Bank loans to the economy



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 9 March 2009.

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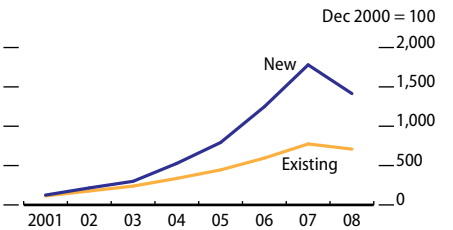
3.4.4 Residential property prices



Source: Agency of Statistics of the Republic of Kazakhstan.

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boosted by high prices for much of the year and, on the other, to weaker import demand.

Official reserves increased by $1.8 billion during 2008 to $19.4 billion (Figure 3.4.6). The apparent net outflow from the capital and financial account of about $7 billion reflected the $6.3 billion accumulation of foreign assets by the National Fund of the Republic of Kazakhstan (NFRK), the offshore oil windfall savings account. This gain lifted NFRK's total assets to $27.3 billion at end-December 2008. Inflows of FDI, mainly to the oil sector, remained substantial.

Private sector external debt (excluding intracompany debt, which is mainly for oil and gas) grew rapidly in the 3 years to September 2007, to $62.7 billion, or about 60% of GDP. The bulk of it stemmed from the expansion of local bank borrowing from abroad to fund domestic lending. A year later, this debt stood at $68.7 billion (Figure 3.4.7), or about 52% of GDP.

The National Bank of Kazakhstan (NBK) has kept the exchange rate steady at about T120/$1 since the onset of local banks' difficulties in accessing international capital markets. This policy aimed both to sustain public confidence at a time of economic uncertainty and to avoid further burdens on companies and banks that needed to make external debt repayments. (Foreign currency–denominated loans fell to about 45% of total loans, from about 75% at end-2007.)

NBK has indicated that it spent $6.0 billion from October 2008 through January 2009 in maintaining the exchange rate. Official reserves, which had peaked in September at $21.9 billion, fell to $18.3 billion by end-January this year. These reserve losses and an 18% devaluation of the Russian rouble, also in January, made it untenable to continue this policy. On 4 February, the central bank devalued the tenge by about 20% to T150/$1 (Figure 3.4.8), but as before, it intends to keep the rate stable.

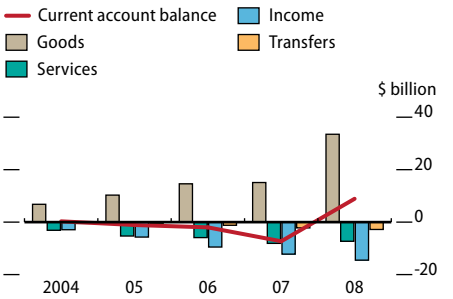
The Government at midyear revised upward the 2008 budget's revenue and expenditure and the targeted deficit from 1.2% to 2.1% of GDP. It aimed to cover increases in social spending by higher than expected oil revenue and increased transfers from the National Oil Fund. In May, it had already introduced a new export tax. For the year, revenue and expenditure grew by 25.4% and 27.5%, respectively, with the deficit amounting to T333.2 billion, or 2.1% of GDP, slightly above the 1.7% of 2007 (Figure 3.4.9). (Including National Oil Fund operations, the budget would have shown a surplus of 3.2% of GDP.)

A 3-year budget framework has been introduced with the 2009 budget. This framework raises wages for public sector workers by 25% annually in 2009–2011. Earlier, the budget framework had assumed an average oil price of $60 per barrel, but the authorities revised downward the base-line oil prices to an average of $40 per barrel in 2009 and $50 in 2010–2011. Due to expectations of slower growth in oil-sector revenue as well as planned increases in social spending, the authorities forecast fiscal deficits of 3.5%, 3.5%, and 2.4%, in 2009–2011.

Economic prospects

GDP growth in 2009 is projected to fall to 2.0%, a function of the difficulties in reviving bank lending and business confidence and of the

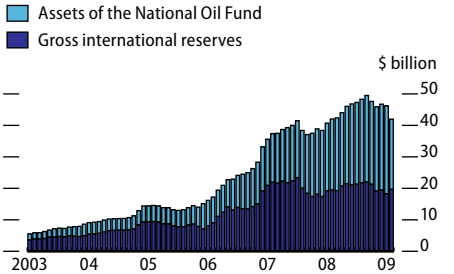
3.4.5 Balance of payment indicators



Sources: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 10 March 2009; staff estimates.

Click here for figure data

3.4.6 Reserves and assets of the National Oil Fund



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 9 March 2009.

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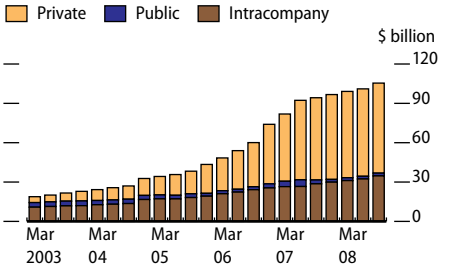
3.4.7 External debt



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 9 March 2009.

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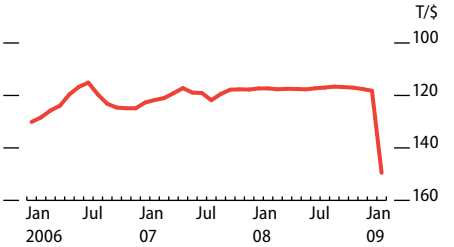
3.4.8 Nominal exchange rate



Source: National Bank of Kazakhstan, available: http://www.nationalbank.kz, downloaded 9 March 2009.

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depressing fallout from slow global growth. A modest increase in growth to 3.3% is assumed for 2010 in the expectation of some improvement in global economic prospects and domestic sentiment.

On the positive side in the outlook for 2009 are the recapitalization of the four largest commercial banks and the creation of a distressed asset fund, which should revive their ability to lend more aggressively; planned assistance to the housing industry; a projected 7.9% gain in oil production (Figure 3.4.10); and the tenge's devaluation (which should maintain competitiveness). The cut in the corporate profit tax from 30% to 20% at the start of 2009 will boost the business sector, and the 25% increase in public sector wages will benefit a large group of workers.

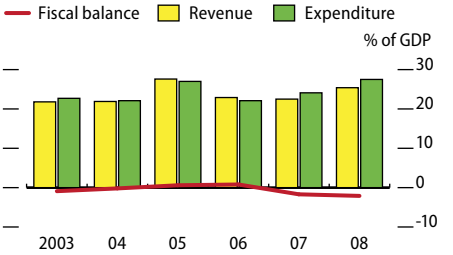
The budget deficit for 2009 is expansionary with the deficit set to widen to 3.5% of GDP. Whether budget spending could be lifted at midyear (if needed to buttress growth) by more than the planned 26% will be a difficult decision as such an increase would likely need to rely on NFRK funding rather than higher than expected oil revenue.

Inflation has come down substantially since its October high. With the decline in food and other commodity prices along with tepid domestic demand, it is expected to fall further to average 10.0% this year and 6.4% in 2010. This offers scope for a more expansive monetary policy. Already in January, NBK cut its refinancing rate by 50 basis points to 10.0% and, at the same time as the February devaluation, by a further 50 basis points, when it also reduced banks' reserve requirements.

Since Kazakhstan's devaluation essentially matched the 18% made by the Russian Federation (a principal source of imports), price pressures from the tenge rate adjustment should be muted. However, maintaining the balance between an accommodative monetary policy and the de facto peg of T150/$1 will be a hard balancing act. Indeed, a major risk for the outlook is the possibility of speculation against the local currency and capital flight, which would need to be thwarted by an increase in domestic interest rates, but that would stunt growth.

The current account is expected to make a sharp swing from a large surplus to a deficit of 2.0% of GDP in 2009, mirroring the steep fall in global oil prices. A notable drop in imports induced by the slide in growth will help keep the current account deficit in check. A deficit of this size does not appear difficult to finance, though debt repayments could result in pressures on the overall balance of payments if access to capital markets closes completely.

3.4.9 Fiscal indicators



Source: Ministry of Finance of Kazakhstan, available: http://www.minfin.kz, downloaded 6 March 2009.

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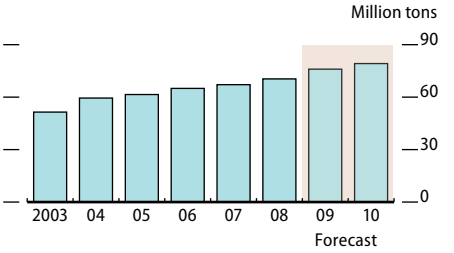
3.4.1 Selected economic indicators (%)

	2009	2010
GDP growth	2.0	3.3
Inflation	10.0	6.4
Current account balance (share of GDP)	-2.0	-0.5

Source: Staff estimates.

3.4.10 Oil production



Sources: Agency of Statistics of the Republic of Kazakhstan; staff estimates.

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Kyrgyz Republic

The economy has faced significant external and domestic shocks in the last year, including high food and energy prices, power shortages, natural disasters, and downturns in the economies of Kazakhstan and the Russian Federation. As a result, economic growth decelerated. Continued prudence in macroeconomic management will be critical for addressing macroeconomic imbalances in the near term. Structural reforms, including in the energy sector, are needed to support growth over the medium term.

Economic performance

From the third quarter of 2007, the small, open Kyrgyz economy has faced significant shocks, including global inflation of food commodities and oil products, a sharp widening of the current account deficit (the country is a net fuel and food importer), severe power shortages, an earthquake, and the spillover effects of an economic slowdown in Kazakhstan and the Russian Federation (with which it has extensive trade and financial links). High inflation is reversing gains made in poverty reduction. In response, the country became one of the first to access the new International Monetary Fund Exogenous Shocks Facility. A recovery in gold production helped maintain respectable growth of 7.6% in 2008 but growth will slow markedly to 4.0% in 2009 as the full impact of the shocks plays out.

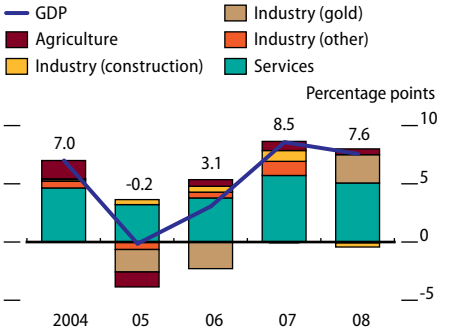
Economic growth was driven by expansion of the services sector and by gold production, with a recovery in production at the Kumtor gold mine from earlier accidents (Figure 3.5.1). (Excluding gold, the economy grew by 5.4%, well below the prior-year 9.0% rate.) A striking difference from previous years was a 10.8% contraction in construction, which had grown at double-digit rates after 2005. This had follow-on effects in supporting industries, such as glass and cement. A 20% drop in hydropower generation (Box 3.5.1) was deleterious for all economic activity and led to a 2% decline in industrial production (excluding gold).

Services growth slowed to 10.7% in response to the weakening economy but continued to make the largest sector contribution to growth. Agriculture, which suffers from low productivity, expanded by only 0.7%.

From the second half of 2007, inflation accelerated sharply: the overall consumer price index was up 20.1% year on year in December 2007, and climbed further to a peak of 32.4% in July 2008 (Figure 3.5.2). Food prices, particularly for bread and cereals, have a heavy weight in the index, and were the dominant factor in the price spike, which reflected mainly the sharp run-up in global wheat prices and the country's heavy dependence on imports.

After July, inflation subsided to 20.0% year on year by end-December 2008. In this period food inflation came down, benefiting from a

3.5.1 Contributions to growth (supply)



Sources: National Statistics Committee of the Kyrgyz Republic; National Bank of the Kyrgyz Republic, available: http://www.nbkr.kg, downloaded 3 March 2009.

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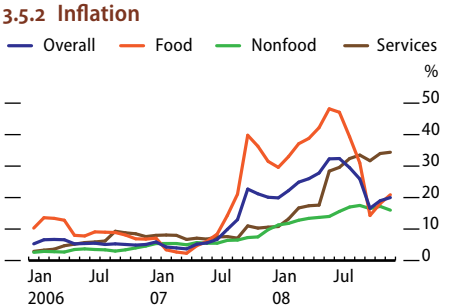
3.5.2 Inflation



Sources: National Statistics Committee of the Kyrgyz Republic; National Bank of the Kyrgyz Republic, available: http://www.nbkr.kg, downloaded 3 March 2009.

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This chapter was written by Nargiza Kasymalieva, consultant of the Kyrgyz Resident Mission, ADB, Bishkek.

3.5.1 Energy shortages

Last year saw electricity generation and exports tumble by about 20% and 75%, respectively. The cause was a very low water level in Toktogul reservoir, which provides about 90% of national power output. The level had fallen to an unprecedented 7 billion cubic meters because of a severe winter in 2007 that led to greater demand for electricity. About 13 billion cubic meters is necessary for winter needs.

Structurally, the main reasons for the energy shortage are overdependence of the economy on hydropower and the chronic lack of investment in basic energy infrastructure. These are largely explained by an inappropriate pricing policy that imposes heavy financial losses on the sector. Management weaknesses also play a part, as does the lack of coordination in—and friction stemming from—regional energy and water use among the Central Asian republics.

The Government has adopted emergency measures to save water at Toktogul dam, including significant limits on electricity consumption, cuts in electricity exports, a ban on electrical heating systems in private homes, and a prolongation of the winter secondary-school holiday in the regions. Heating and electricity tariffs have been increased, but are still way below cost-recovery levels.

The National Energy Program (adopted in 2008) allows for the privatization of some segments of the state-owned energy sector and private entry into new power generation.

The current energy insecurity in a potentially hydropower-rich nation highlights the need to accelerate structural reforms in energy—including institutional arrangements, tariffs, and financing—to attract private investment. If these energy shortages persist, serious consequences could ensue, not just for social welfare and economic growth but also for the country's fragile political stability.

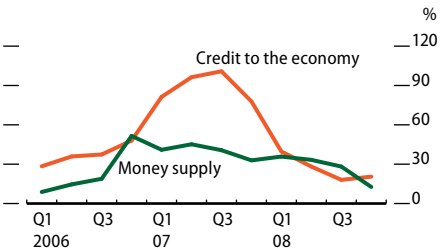
marked drop in global wheat prices; however, a pickup in the services index as the Government raised electricity tariffs limited the fall in overall inflation. For 2008 inflation averaged 24.5%, compared to 10.2% in 2007.

Monetary policy was tightened substantially in 2008 as reflected in the Treasury bill rate climbing to 20% by end-December from 5.7% a year earlier. Growth in the money supply was markedly reduced to 12.6% from 33.3% in 2007 (Figure 3.5.3). Expansion in credit to the economy fell even further, to 20.5% from 80.1% a year earlier. This slowdown resulted from a crimping in funding from head offices to Kazakh-owned banks in the country, which account for about half the banking system. While no outflow of funds is apparent, Kazakh parent banks continue to suffer from their own financial pressures and may not roll over funding to their subsidiaries when liabilities fall due this year.

The National Bank of the Kyrgyz Republic, the central bank, allows the exchange rate to adjust and intervenes only to smooth sharp movements. The som has depreciated by almost 12% against the United States dollar since August 2008, reflecting the dollar's appreciation internationally. Given the large import content of consumption, the central bank has supported the rate to limit inflation pressures by sales of foreign exchange, and official reserves fell by nearly 5% in the fourth quarter. The real effective exchange rate appreciated by 7.9% in 2008, as a result of higher inflation in the Kyrgyz Republic than in trading partner countries (Figure 3.5.4).

Fiscal performance in 2008 was relatively strong despite increased spending pressures for wages and energy. The budget deficit was contained at around 1.9% of GDP (or about 4.8% of GDP if grants are excluded) (Figure 3.5.5). This was due to better than expected revenue collections and cuts in nonpriority spending. The authorities increased assistance to the poor in October 2008 by raising the main targeted social

3.5.3 Money supply (M2x) growth



Sources: International Monetary Fund, *International Financial Statistics* online database; National Bank of the Kyrgyz Republic, available: http://www.nbkr.kg, downloaded 3 March 2009.

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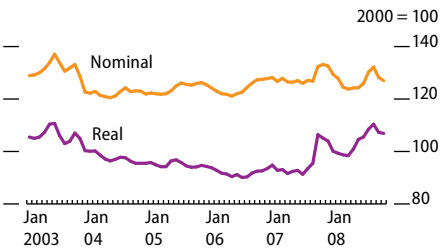
3.5.4 Effective exchange rates



Source: National Bank of the Kyrgyz Republic, *Balance of Payments of the Kyrgyz Republic* (various issues), available: http://www.nbkr.kg, downloaded 3 March 2009.

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benefit, from an average of $3 per month per recipient to $4. Donor grants covered this increase initially, and government resources will do so later.

Higher fuel and food import bills widened the current account deficit to an estimated 10.5% of GDP in 2008 (Figure 3.5.6); their net annual import cost is estimated to have risen by almost $300 million in 2008. Exports recorded robust growth of about 39.0%, driven by gold and other items such as textiles, mineral products, and precious and semiprecious stones. Imports grew by about 38.4%, but from a larger base, expanding the trade deficit by nearly $500 million. Remittances as a share of GDP stayed at around 25%, representing an increase of about one fifth compared to the previous year.

Foreign direct investment flows were largely unchanged in 2008, though other capital and financial flows accelerated to finance the larger current account deficit and provided for an increase in reserves. Gross official reserves increased by $48 million to about $1.2 billion at end-December (Figure 3.5.7), equivalent to around 4 months of imports.

Good progress was made in the business environment, as seen in the country's much improved ranking in the *Doing Business 2009* report to 68, from 99. The Kyrgyz Republic improved investor perceptions by amending a law to allow minority investors to take legal action as shareholders. A one-stop shop was established to ease business registration. The Pledge Law and the Civil Code were amended to allow for out-of-court procedures to seize collateral. Finally, the Civil Code was amended to allow the sharing of borrower information with third parties, including credit bureaus.

In 2008, the Government further intensified efforts to reduce hindrances to open trade. It is also pressing ahead with public financial management reforms. A new law governing internal audits of government agencies and institutions establishes a framework for conducting audits in line with international best practice. In the financial sector, Parliament has approved a plan for privatizing Aiyl Bank, the largest nonbank financial institution, and introducing a deposit insurance scheme, which will come into effect next year.

Structural reforms could be advanced further in other key areas such as energy, pensions, trade facilitation, customs administration, and property rights. In addition, rules-based governance is weak. Transparency International's 2008 Corruption Perceptions Index shows that corruption remains a challenge, too: the country's performance deteriorated from 2.1 in 2007 to 1.8 in 2008 (on a scale of 0 to 10).

Economic prospects

The global financial crisis and economic downturn, as mediated through the sharp deceleration of the economies of Kazakhstan and, especially, the Russian Federation, have hit this poor economy through a range of channels. Combined with weaker domestic demand, the effects are expected to slow GDP growth to 4.0% in 2009, with some pickup to 6.0% in 2010, provided that the global economy (including these two countries) recovers a little.

Although monetary policy aims to cut average consumer price inflation to single digits, given the need to support economic growth, it

3.5.5 Budget balance

Source: International Monetary Fund, *Country Reports* (various issues), available http://www.imf.org/external/country/KGZ/index.htm.

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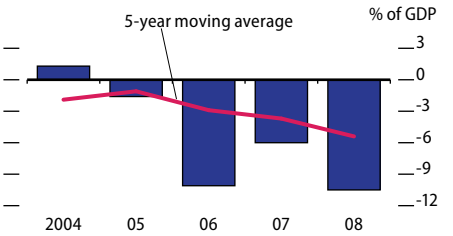
3.5.6 Current account balance



Sources: National Bank of the Kyrgyz Republic, *Balance of Payments of the Kyrgyz Republic* (various issues), available: www.nbkr.kg; International Monetary Fund, *Country Reports* (various issues), available: http://www.imf.org/external/country/KGZ/index.htm, both downloaded 4 March 2009.

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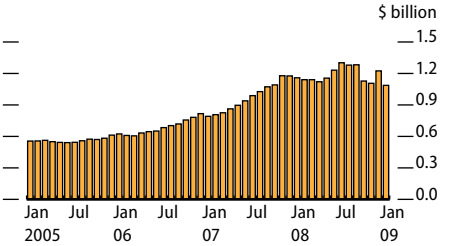
3.5.7 Gross international reserves



Source: National Bank of the Kyrgyz Republic, available: http://www.nbkr.kg, downloaded 4 March 2009.

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is unlikely to be lower than 15.0% in 2009 and 12.0% in 2010. To foster macroeconomic stability, the central bank and the Ministry of Finance are reinforcing coordination, especially regarding domestic debt issuance and liquidity management.

With a large import element in the consumer basket, the authorities will use the exchange rate channel, to the extent possible, to deflate inflation pressures. They also aim to contain the overall budget deficit. They will make any needed spending cuts to offset the net revenue loss due to the introduction of a new tax code, which among other things lowered the value-added tax rate from 20% to 12%. They intend to make up that revenue loss by bringing in property and turnover taxes, which will replace the existing sales, road, and emergency taxes.

The current account deficit is projected to remain large in the period ahead at about 10.0% of GDP, as external demand weakens and remittance inflows slow due to adverse conditions in the country's main trading partners. The price of imported natural gas from Uzbekistan was increased early this year from $145 per cubic meter to $240, which will boost imports, though slower economic growth will provide something of an offset. Three agreements signed with the Russian Federation early this year will add to the financing already arranged elsewhere to cover the deficit.

A range of risks looms over the medium-term outlook, including a more severe than expected economic downturn in Kazakhstan and the Russian Federation, worsening infrastructure constraints (mainly power shortages), and vulnerability to natural disasters. Still-higher inflation plus deteriorating economic conditions may spur public discontent and protests.

3.5.1 Selected economic indicators (%)

	2009	2010
GDP growth	4.0	6.0
Inflation	15.0	12.0
Current account balance (share of GDP)	-10.0	-10.0

Source: Staff estimates.

Development challenges

In addition to the challenges from the global and regional downturns, the spike in global food prices in 2008 showed that food security is an issue for the country, as a net importer of food. Internally, the long-standing water–energy problem resulting from a lack of investment and poor management has further undermined the economy.

Perhaps the main issue currently facing the Government is to minimize the damage done by the global financial crisis and economic downturn, including job and income losses, and the erosion of the impressive poverty reduction of the past few years. This will not be easy, especially in light of considerable pressure on public financial resources in a weakening economy.

The Government recognizes that sustainable inclusive growth is not only key to raising people's living standards and poverty reduction, but also to building up the economy's resilience to external and internal shocks. It has recently reaffirmed its focus on long-term growth despite urgent short-term difficulties. In this respect, further structural reforms in the energy (and other) sectors, along with continued efforts to improve investment and the business environment, are essential.

Tajikistan

Winter energy shortages failed to derail another year of strong growth, but structurally the country faces difficult economic and social conditions, including a high poverty rate, an unfavorable investment climate, and weak infrastructure. In the short term, growth will be affected by the global—and especially regional—slowdown. A continued, heavy fall in workers' remittances, a major source of family income and foreign exchange, is a major risk. The country is facing the adverse impact of the global financial crisis and economic downturn, and the Government and donors are making efforts to mitigate economic losses.

Economic performance

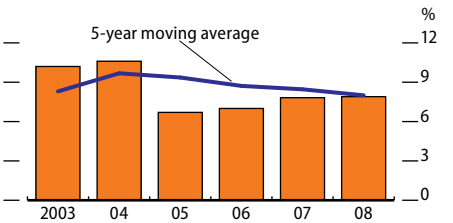
In 2008, the economy posted solid growth estimated at 7.9%, despite a decline in industrial production and contraction in the key aluminum and cotton subsectors (Figure 3.6.1).

Industrial production as a whole declined by 4% in 2008. Including aluminum production, industry was hit by an energy crisis (and subsequent power rationing) that was triggered by an unusually cold winter in 2008. This lowered the water level in the country's largest reservoir below that needed for generating normal hydropower supplies. Among three important subindustries that had been major drivers of industrial growth in 2007—food processing, construction materials, and textiles—only food processing posted any growth, of just 0.6%. The authorities ensured that this subindustry was less affected by the rationing because of its strategic importance.

Agriculture picked up to 7.9% growth in 2008 from 6.5%, supported by robust expansion in noncotton subsectors, including livestock and fruits and vegetables, as higher global prices made food production more profitable. The area planted to cotton was reduced further in 2008, allowing farmers to grow other crops. The cotton subsector continued to suffer from low productivity, a legacy of heavy debt and a sluggish pace of structural reform. Services rapidly expanded, boosted by strong performance in the construction, trade, and finance subsectors. Construction activity was buoyed by large disbursements on externally and internally financed infrastructure projects. The strong expansion in services offset the decline in industrial production.

Growth in consumption and investment supported expansion in aggregate demand; the contribution of net exports was negative, as imports continued to expand faster than exports. Growth in consumption was heavily supported by remittances, which were estimated at about half of GDP in 2008, up from below two fifths in 2007. Investment growth was underpinned by foreign direct investment inflows and official development assistance, largely for financing infrastructure projects.

3.6.1 GDP growth



Sources: State Statistical Committee of the Republic of Tajikistan, available: http://www.stat.tj, downloaded 27 February 2009; staff estimates.

Click here for figure data

This chapter was written by Zafardjon Khotamov of the Tajikistan Resident Mission, ADB, Dushanbe.

Inflation fell to 11.9% in December 2008 from 19.9% a year earlier (Figure 3.6.2), though the average annual rate remained relatively high at 20.7%. Wheat was a major driver, due to a global price spike and the sizable weight of wheat products in the consumer price index basket. In the last quarter, the retreat in international food prices, and the removal of a wheat export ban from Kazakhstan, helped bring wheat and other food prices down. (Most of the country's food and energy needs, including wheat, are met through imports.)

Utility prices, including natural gas and electricity, also jumped in 2008, owing to higher prices for imported natural gas from Uzbekistan and a hike in electricity tariffs. Fuel prices did not immediately decline with the retreat in international oil prices in the last quarter of 2008, because lower prices were not fully passed through due to rigidities in the domestic market, such as small market size, few importers, and slow inventory adjustment.

A surge in remittances created pressures for the local currency, the somoni, to appreciate in the first half of 2008. To counter them, the National Bank of Tajikistan (NBT) bought foreign exchange to build its low international reserves and to forestall a loss in competitiveness. The nominal exchange rate was kept broadly stable at around TJS3.43/$1 throughout the year (Figure 3.6.3). Remittances grew at an estimated 50% in 2008, though receipts showed a marked slowing in the fourth quarter.

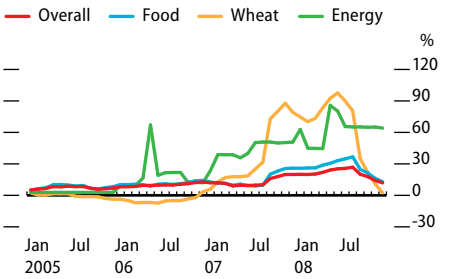
NBT refrained from providing direct credit to the economy, helping lower reserve money growth to an estimated 27%, from 40.3% in 2007. Broad money growth is estimated at about 33.1% in 2008, compared to 78.8% in 2007, as growth in credit slowed.

Revenue and expenditure, excluding the externally financed portion of the Public Investment Program (PIP), are estimated at 20.9% and 19.9% of GDP, respectively, in 2008. The Government achieved the 1% fiscal surplus, due to stronger revenue performance stemming from high nominal growth, improved tax administration, and increased imports.

Including the externally financed portion of the PIP, expenditure was estimated at 28.5% of GDP and revenue at 21.4% (a deficit of 7.2% of GDP) (Figure 3.6.4). Current spending and net lending came in at 15.4% of GDP, including wages and salaries (of 4.3% of GDP). Capital expenditure (13.8% of GDP) comprised externally financed PIP (9.3%) and domestically financed spending (4.5%). Disbursements of the PIP exceeded the planned program as projects moved faster than anticipated.

The current account deficit is estimated to have narrowed to 9.3% of GDP in 2008 from 11.2% in 2007 (Figure 3.6.5), a reflection of the gain in workers' remittances, prompted in part by the jump in domestic food and energy prices. The growth of remittances slowed in the last quarter, as the global slowdown increasingly affected the Russian Federation (the main source of remittances) and Kazakhstan. Although import growth decelerated relative to 2007, imports were about seven times the size of exports. The financing of the heavy trade deficit (and the smaller services and income deficit) was fully dependent on remittance transfers and capital inflows. Import growth was driven largely by goods for household consumption and by construction materials for infrastructure projects. Gross official reserves at year-end are estimated at $169 million (Figure 3.6.6), equivalent to about 1 month of imports in 2008.

3.6.2 Inflation



Source: State Statistical Committee of the Republic of Tajikistan, available: http://www.stat.tj, downloaded 2 February 2009.

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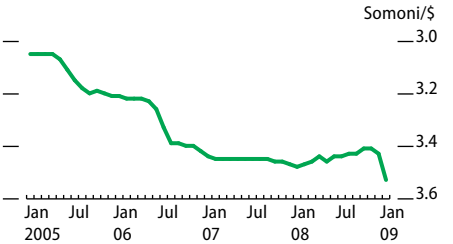
3.6.3 Exchange rate



Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 4 March 2009.

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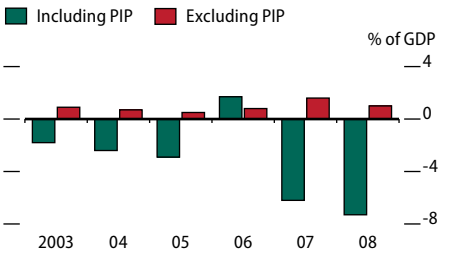
3.6.4 Fiscal balance



PIP = Public Investment Program.

Source: International Monetary Fund, *Country Report* Nos. 07/144 and 08/382, available: http://www.imf.org/external/country/TJK/index.htm.

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Energy has been attracting significant investment in recent years, through a combination of significant indigenous hydropower potential, growing demand (especially foreign) for energy, and a domestic energy infrastructure degraded by many years of underinvestment. To complement the investment, the Government has started implementing reforms to improve the economic viability and management of the sector. Electricity prices are being raised to cost-recovery levels, as part of which the tariff for the public was virtually doubled to 2 cents per kilowatt-hour at the start of 2009. To cushion the impact, the Government has allocated a budget for the poor and other vulnerable groups.

The slow pace of reform in agriculture, including cotton, and the cotton debt problem are impeding growth. Some moves were made in 2008, though. A decree was adopted that abolishes cotton export licensing by NBT. Also, to enhance transparency, the cotton subsector was financed through a new mechanism, whereby the Government provided funds at low interest rates through commercial banks. However, the mechanism is unsustainable as collecting loan repayments from indebted cotton sector farmers will remain very difficult for commercial banks. The decline in global cotton prices, low productivity, and inefficient cotton ginning and marketing are heavy burdens on the subsector.

The Government made good progress on the Staff-Monitored Program of the International Monetary Fund (IMF). It also adopted a new 3-year debt management strategy, which sets the limit of new public external borrowing in line with the IMF–World Bank Debt Sustainability Analysis (published in March 2007) at 40% of GDP. External debt is estimated at 30% in 2008 (Figure 3.6.7).

Public financial management received attention in 2008. In accordance with the IMF Staff-Monitored Program, a special audit of NBT was conducted, and the Government issued a decree establishing a supervision unit in the Ministry of Finance for regular monitoring of the financial operations of the 10 largest state enterprises.

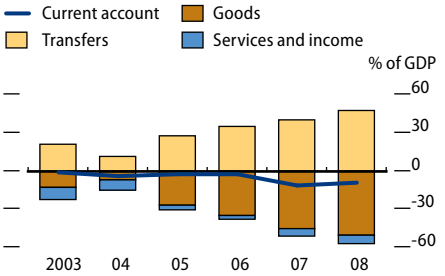
Economic prospects

The external environment—particularly in the Russian Federation—will be extremely demanding in 2009. Falling remittances and sluggish exports will weaken the external balance. Remittances are projected to go down by about 30% this year, possibly more, and were already down by about 22% in January, year on year. The liquidity problems in the banking system may create disincentives for migrants to use it as a channel for making transfers, thus risking losses in an important source of foreign exchange and disruption in formal economic activity. Export earnings will decline due to both price and volume effects stemming from lower demand for aluminum and cotton. World prices, including oil and food, are expected to fall, easing import costs; natural gas import prices, though, will stay high.

Monetary policy will aim to tighten money growth. NBT will not provide direct credits to banks or the economy; growth in reserve money will come from the Government as it draws down its deposits at NBT to finance part of the budget deficit.

Real GDP growth is forecast to fall in 2009 to 3.0%, reflecting the

3.6.5 Current account indicators



Source: International Monetary Fund, *Country Report* Nos. 07/144 and 08/382, available: http://www.imf.org/external/country/TJK/index.htm.

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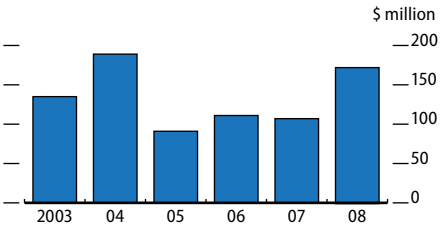
3.6.6 Gross international reserves



Sources: International Monetary Fund, *Country Report* Nos. 07/144 and 08/382, available: http://www.imf.org/external/country/TJK/index.htm; National Bank of Tajikistan.

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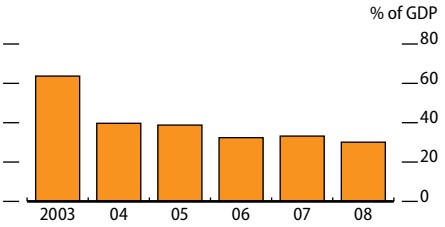
3.6.7 External debt



Source: International Monetary Fund, *Country Report* Nos. 07/144 and 08/382, available: http://www.imf.org/external/country/TJK/index.htm.

Click here for figure data

3.6.1 Selected economic indicators (%)

	2009	2010
GDP growth	3.0	4.0
Inflation	15.5	9.5
Current account balance (share of GDP)	-8.8	-7.0

Source: Staff estimates.

global slowdown. Services growth, the main driver in recent years, will decelerate as remittances decline and credit dries up. The financial system will have difficulties in increasing lending to the economy due to tighter monetary policy and liquidity shortages in the system. Lower international prices and demand for aluminum, as well as weaker domestic spending, will keep industry a drag on growth. Agriculture, though, is expected to continue expanding on favorable supply and demand factors.

Noncotton agriculture, which was a growth driver in 2008, should benefit from the loans allocated from the budget through banks and from a further reduction in the cotton-planted area. Moreover, consumers are expected to switch from imported food to domestically produced food, due to the impact of falling remittances on incomes and prices.

On the expenditure side, lower remittances will slow consumption and consumption-related imports. Investment, however, is expected to grow within the framework of the budgeted infrastructure-related capital spending.

The economy is expected to pick up slightly in 2010 to 4.0%, as new hydropower plants become operational, which will limit energy shortfalls and boost exports. The pickup also depends on some recovery in the global economy and the availability of funding, particularly external private capital and development assistance.

Macroeconomic stability is the major objective of the authorities' economic program. The Government is revising its 2009 budget to reflect the expected impact of worsening economic conditions on revenue collection, and has budgeted a targeted 0.5% of GDP deficit in 2009 (excluding the externally financed portion of the PIP). The budget allocated large increases for health and education, and apportioned funds for lending to agriculture through commercial banks. However, as revenue performance has substantial downside risks, expenditure items will likely need to be revised down, but planned social sector spending may well be maintained. The global donor community is providing support for the financing gap of 2009; additional funding will almost certainly be needed.

Inflation is expected to ease to 15.5% this year and to 9.5% next year, helped by trends in global food and energy prices and weaker domestic demand. Food and energy items are the main determinants of inflation in Tajikistan, given their large weight in the consumer price index basket. The slowdown in the domestic economy and declining remittances will reduce demand-pull pressures.

The current account deficit is projected at 8.8% of GDP in 2009 and 7.0% in 2010. Imports of capital goods related to ongoing PIP projects will be the major driver of the current account deficit and will mirror the fiscal deficits. Consumer goods imports will continue to be covered by remittances, though imports of consumer goods will remain relatively high until savings are depleted. External developments will probably keep export growth essentially stagnant in 2009, with a modest increase in 2010.

The major downside risk to economic prospects in over the forecast period will be the depth of the global and regional recessions. If remittances tumble, this will further damp economic activity and lead to greater external adjustment.

3.6.1 Development challenges

Strategies that the Government adopted at the start of the millennium envisaged a graduation to managing a long-term development process, from the crisis management strategies of the 1990s when the country suffered from civil conflict, macroeconomic instability, and food insecurity. The past year, however, has demonstrated the recurrent fragility of the economy to crises, forcing the Government both to manage the crisis while guiding longer-term strategies.

Remittance dependency has been growing in recent years, reflecting sluggish domestic production and export growth, and some one third of the labor force now works abroad. Although the financial inflows have supported growth and spending, the human outflows have created shortages of labor for certain skills (and disincentives for other family members to work at home).

Managing this dependency is difficult. Employment of returning migrants relies on local job creation, the pace of which in turn hinges on private sector development. And although the Government has started to improve the investment climate for private business where it can by spending more on physical infrastructure, some limitations, such as geography, are immutable.

Turkmenistan

The economy continued its strong double-digit growth in 2008, driven once more by production and exports of hydrocarbon products and public investment. The current account surplus more than doubled. Inflation accelerated due to the unification of the dual exchange rate, liberalization of gasoline and diesel prices, and hikes in prices of imported foodstuffs. The challenge is to diversify the economy by developing the nonhydrocarbon sector through the private sector, while overcoming legacy constraints. Nonetheless, the Government is making efforts in reforming the economy.

Economic performance

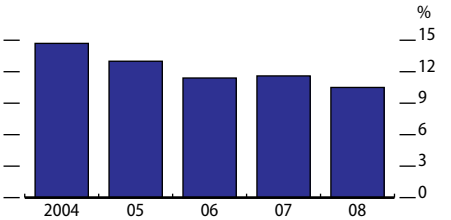
Turkmenistan is at a very early stage of integrating itself into the world economy, and so the global financial crisis has not had a significant direct impact. Indeed, the economy continued its strong growth in 2008, posting 10.5% GDP growth (Figure 3.7.1). The main drivers were the production and exports of hydrocarbon products and public investment. Hydrocarbon products account for about 90% of total exports, while much public investment relates to the construction of public buildings and new industrial facilities, as well as to roads and railways. On the supply side, construction (mainly infrastructure and buildings) showed substantial growth.

Official statistics report an inflation rate of 8.9% in 2008, which was significantly higher than the previous year's figure of 6.3% (Figure 3.7.2). Several factors contributed to this acceleration, including the unification of the official and unofficial exchange rates (of TMM6,250 and TMM20,000 per US dollar), at 14,250 on 1 May 2008; the liberalization of gasoline and diesel prices in February 2008 (the Government introduced fuel allowances to mitigate the impact on consumers); and higher prices of imported foodstuffs (mainly in the first half). At present, the Central Bank of Turkmenistan has limited monetary policy tools to control inflation because of the rudimentary development of the financial system.

The Government is running a tight fiscal policy, according to official statistics. The budget surplus is estimated to have been 4.3% of GDP in 2008, up from 3.9% in 2007 (Figure 3.7.3). Public sector revenue derives largely from incomes of oil and natural gas, which were buoyant. Spending has increased, reflecting higher public sector wages, pensions, and allowances, as well as capital outlays and the rural development program, which aims to improve living conditions and social infrastructure in the countryside.

With booming hydrocarbon revenues, the current account surplus jumped by 43.7% in 2008, to $5.8 billion or 33.4% of GDP (Figure 3.7.4). Exports increased by 30.6%, totaling $11.9 billion. Natural gas accounts for

3.7.1 GDP growth



Sources: International Monetary Fund, *Regional Economic Outlook, Middle East and Central Asia*, October 2008, available: http://www.imf.org; staff estimates.

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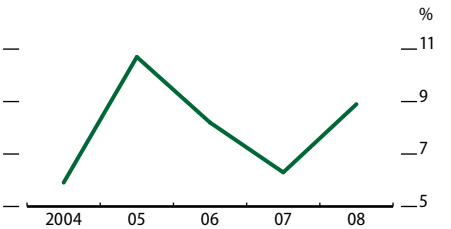
3.7.2 Inflation



Source: International Monetary Fund, *Regional Economic Outlook, Middle East and Central Asia*, October 2008, available: http://www.imf.org.

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This chapter was written by Philip Chang of the Central and West Asia Department, ADB, Manila.

52%, petroleum products 24%, and crude oil 14% of total exports. Imports grew by 50.8%, to reach $5.7 billion; about 75% of imports were capital goods used for construction. Foreign direct investment surged by 40%, to $1,199.7 million.

The Government recognizes the need to diversify the economy by promoting private sector development and investment in nonhydrocarbon activity, and launched several structural reform measures in 2008. The exchange rate unification, removal of limits on foreign exchange transactions, and redenomination of the manat (with one new manat equivalent to 5,000 old manat) on 1 January 2009 are positive steps. It is also gradually liberalizing the financial sector. In June 2008, it issued new foreign exchange regulations, which enable the central bank to provide banks with ready access to foreign exchange and allow commercial banks to open correspondent bank accounts to facilitate trade finance.

To, among other things, boost foreign investment, the Government approved a new constitution that highlights the protection of private property rights. It also passed new laws and legal reforms on foreign investment, licensing, and special economic zones; amended the tax code; abolished duty on imports of some foodstuffs; and lowered duty on some other products. In addition, in October 2008, the president signed a decree permitting the Ministry of Finance to establish a stabilization fund as a cushion against the impact of the global slowdown.

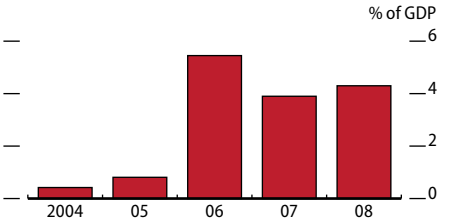
Economic prospects

The outlook for the economy remains positive. The key drivers of growth will continue to be hydrocarbons and public investment. The Government has negotiated favorable offtake natural gas prices and volumes with the Russian Federation for 2009 and beyond. It forecasts growth to continue, at 10.0% in 2009 and 2010. Higher export values will boost the current account surpluses, estimated at around 35.0% of GDP in both 2009 and 2010.

Parliament approved a 40% increase in fiscal expenditure for 2009, at TMM294.5 trillion. Spending on economic and infrastructure development will increase by 43%; and on education, health care, and social welfare by 13%. The Government forecasts inflation of 7–8% this year. However, these increases in fiscal expenditure, and in public sector wages, pensions, and allowances, will put significant pressure on aggregate demand, and consequently *ADO 2009* forecasts inflation staying high, at 12.0% in 2009 and 10.0% in 2010.

The Government aims to diversify the production base and export base, as well as to promote private sector development, by increasing the private sector share of GDP from 40% to 70%. It also aims to develop chemical, engineering, food, and construction materials. Major obstacles to development and diversification include administrative, institutional, and human resources constraints.

3.7.3 General government fiscal balance



Sources: International Monetary Fund, *Regional Economic Outlook: Middle East and Central Asia*, October 2008; Turkmenistan Ministry of Finance; staff estimates.

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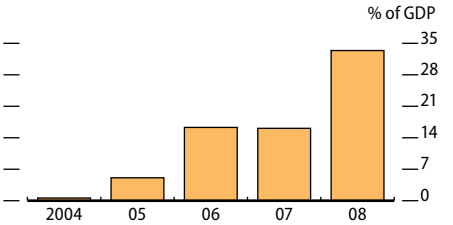
3.7.4 Current account balance



Sources: International Monetary Fund, *Regional Economic Outlook, Middle East and Central Asia*, October 2008, available: http://www.imf.org; staff estimates.

Click here for figure data

3.7.1 Selected economic indicators (%)

	2009	2010
GDP growth	10.0	10.0
Inflation	12.0	10.0
Current account balance (share of GDP)	35.0	35.0

Source: Staff estimates.

Uzbekistan

A favorable export environment and prudent fiscal and monetary policies have driven strong economic performance in the last few years. But in the second half of 2008, the economy started slowing as international commodity prices retreated. Although the global financial crisis has hardly touched the domestic financial sector directly, the economic downturn has slowed exports, remittances, and investment. Rising unemployment and inflation will hinder government efforts to stimulate demand, and successful implementation of anticrisis policies will require acceleration of structural reforms.

Economic performance

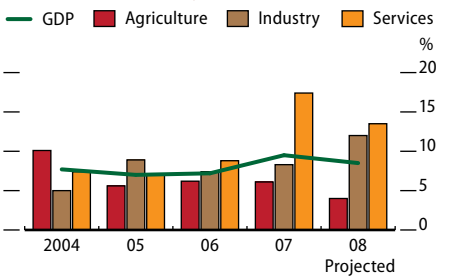
GDP growth in 2008 declined to an estimated 8.5% from 9.5%, largely due to the decline in services growth stemming from the high-base effect of the previous year (Figure 3.8.1). Industry, with 12.0% growth, was led by increased production of fuel, machinery, and metals, which collectively posted a 21.5% expansion (and which accounted for 33.5% of total industrial output). The hydrocarbon and metals-producing subsectors have boomed in recent years as a result of surging global commodity prices, buoyant external demand, and heavy public and private investment. Gold production in 2008 rose by 3%, to 80 tons, and automobile production strengthened.

Services expansion (13.5%) reflected rising receipts from gas transit, burgeoning telecommunications, and a growing financial market. Agriculture lagged behind, growing by only 4.0% in 2008. Drought affected both cereal and cotton production; additionally, degrading soil quality hit cereal output particularly, and a smaller sown area cut cotton production.

Driven by high international prices and strong external demand, exports grew by 25.0% in 2008, with energy, cotton, and metals accounting for half the export revenue. Although toward the end of the year international prices for metals retreated from their historical highs, their average annual levels were still high. Uzbekistan secured a 40% increase for the bulk of its gas exports for 2008, to approximately $300 per 1,000 cubic meters.

The contribution of current transfers to the current account surplus showed a substantial gain in 2008 due to the sharp increase in remittance inflows, largely from the two main destination countries for migrant workers—Kazakhstan and the Russian Federation. Based on data from the Central Bank of the Russian Federation, remittances from that country through formal channels to Uzbekistan in 2008 are estimated at $3.3 billion, or 13% of Uzbekistan's GDP, which is twice the prior-year level. Many migrant workers, however, were reportedly returning home because of job losses toward the end of 2008.

3.8.1 GDP growth by sector



Sources: International Monetary Fund, *Regional Economic Outlook, Middle East and Central Asia*, October 2008, available: http://www.imf.org; State Statistics Committee of Uzbekistan; staff estimates.

Click here for figure data

This chapter was written by Kiyoshi Taniguchi and Iskandar Gulamov of the Uzbekistan Resident Mission, ADB, Tashkent.

In a context of numerous import restrictions and importers' reported difficulties in obtaining hard currency for trade purposes, imports grew by only 15.0% to $7.0 billion. The largest import item was machinery and equipment, mainly in the hydrocarbon and communications subsectors. The current account balance is estimated at $4.7 billion, or 18.0% of GDP (Figure 3.8.2).

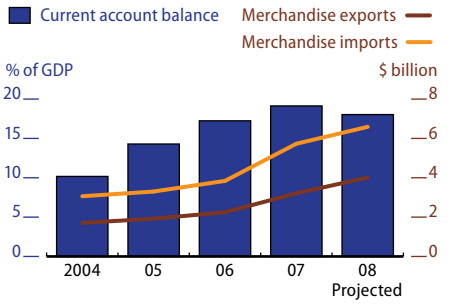
The capital account is expected to have been in deficit by approximately $1.7 billion in 2008, down from the $2.1 billion deficit posted in 2007. The narrowing was due to rising foreign investment and lower levels of external debt service. Foreign direct investment rose to approximately $1.0 billion and the ratio of external debt to GDP declined to 15.4% of GDP.

The greater part of foreign capital inflows came in the first half of the year; the global financial crisis in the second half limited the investment capacity of major investors—Russian and Asian oil and telecoms companies. Large overall surpluses and the Government's conservative external borrowing policy allowed further accumulation of gross official reserves of $2.7 billion, to an estimated $10 billion at year-end (Figure 3.8.3).

According to the International Monetary Fund, inflation in 2008 was 13.0%, or slightly above the 2007 rate (Figure 3.8.4). Inflation pressures came from the global rise in food prices in the first 6 months of the year, increases in government-administered wages, hikes in prices of utilities, and depreciation of the local currency against the United States dollar. These pressures, however, were somewhat mitigated by slower money supply growth: M2 decelerated to 32.4% in 2008 as a result of slower growth in net foreign assets, continued accumulation of foreign exchange revenue in the Fund for Reconstruction and Development (FRD), and a greater volume of sterilization operations by the Central Bank of Uzbekistan.

The general government budget is estimated to have posted a surplus of 2.0% of GDP in 2008 (Figure 3.8.5). (Including the surplus of FRD, the government budget surplus amounted to 8.0% of GDP.) Budget revenue increased, because state enterprises benefited from high commodity and utility prices, particularly for hydrocarbons. The revenue gain was sufficient to cover hikes in public sector wages and social spending.

3.8.2 External sector



Sources: International Monetary Fund, *Article IV Consultation*, July 2008, available: http://www.imf.org; staff estimates.

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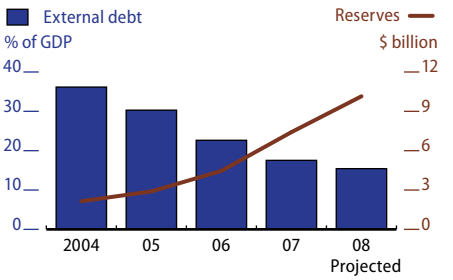
3.8.3 Reserves and external debt



Sources: International Monetary Fund, *Article IV Consultation*, July 2008, available: http://www.imf.org; staff estimates.

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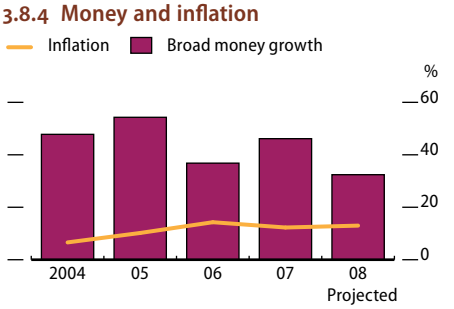
Economic prospects

Due to the isolated and underdeveloped nature of the financial system, Uzbekistan will not be affected by the global financial crisis directly. Instead, the global economic downturn is impacting the economy via exports and remittances.

The contraction in external demand for major export commodities (excluding gas) and the decline in commodity prices in 2008 are expected to continue in 2009–2010. Remittance inflows will shrink as economic difficulties in Kazakhstan and the Russian Federation persist. An increase in gas exports, which are expected to double in dollar terms this year, will partly offset the decline in nonhydrocarbon exports.

The current account balance will remain in surplus, aided by lower import prices for consumer goods and fewer imports of capital goods. Also, the Government is expected to impose tighter import restrictions

3.8.4 Money and inflation



Sources: International Monetary Fund, *Regional Economic Outlook, Middle East and Central Asia*, October 2008, available: http://www.imf.org; State Statistics Committee of Uzbekistan; staff estimates.

Click here for figure data

to limit foreign exchange outflows. Moreover, it has announced plans to expand import substitution through public procurement by giving preferential treatment for locally produced goods and services.

Responding to the need to sustain economic growth, employment, and social stability, the Government outlined a large-scale anticrisis package in four presidential decrees at the end of 2008. It is targeted at export promotion, greater demand for domestically produced goods, higher energy efficiency, and more development of small and medium-sized enterprises (SMEs). To help meet these objectives, the Government will increase domestic investment through budget spending and FRD investment. Much of the public investment will be directed toward transport and social services in rural areas. In addition, the Government has pledged to raise all public-sector wages, pensions, and social benefits by 150% during 2008–2010.

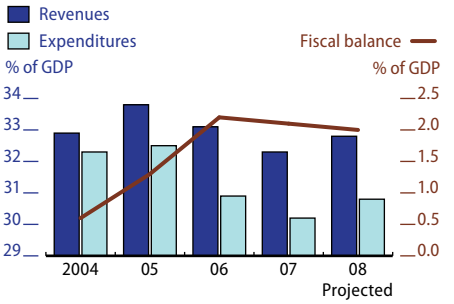
The Government wants to boost commercial banks' lending to the economy through central bank loans to the banking sector, recapitalization of several major commercial banks, and increased lending from FRD. The Government will also provide subsidized lending to SMEs. Recognizing the increasing demand for microfinance services, the anticrisis package envisages expansion of credit lines to nonbanking financial institutions by the Microcredit Bank. As well as the additional budget spending, the Government will provide numerous tax reductions, mainly to exporting industries and SMEs.

Overall, the cost of the stimulus package is estimated at 4% of GDP. As a result, the consolidated budget will post a deficit of 0.5–1.0% of GDP in the forecast period. These stimulus measures are expected to help sustain GDP growth at about 7.0% in 2009 and 6.5% in 2010.

Inflation is forecast to stay within its 2007–2008 bands. Inflation pressures will stem from expansionary fiscal and exchange rate policies, but will be offset a little by a government-imposed price cap on energy and utility prices in early 2009, lower prices of imported goods, and the central bank's money market operations. (The central bank has announced plans to increase the volume of its certificates of deposit by 50% this year to sterilize excess liquidity.)

Even with the Government's anticrisis package, the forecasts carry downside risks. The package is only likely to be successful in a context of high-quality public administration, governance, and transparency. Government commitment to these areas is crucial.

3.8.5 Fiscal position



Note: The fiscal position excludes the Fund for Reconstruction and Development.

Sources: International Monetary Fund, *Article IV Consultation*, July 2008, available: http://www.imf.org; staff estimates.

Click here for figure data

3.8.1 Selected economic indicators (%)

	2009	2010
GDP growth	7.0	6.5
Inflation	12.5	13.0
Current account balance (share of GDP)	11.0	10.5

Source: Staff estimates.

Development challenges

To mitigate the adverse impacts of the global economic downturn in the short term, the Government needs to reinvigorate internal demand by generating employment opportunities, increasing access to financial services, and fostering private sector growth.

In the medium term, industrial diversification, long-awaited liberalization of the banking system, trade liberalization, and the strengthening of an enabling environment for private sector development will not only help absorb the impact of the global turmoil with minimal economic and social costs, but will also pave the way for sustained, long-run economic growth.

East Asia

People's Republic of China
Hong Kong, China
Republic of Korea
Mongolia
Taipei,China

People's Republic of China

An easing in domestic demand, compounded by weaknesses in exports, weighed on economic growth last year. The property boom cooled as a result of policy measures. Exports fell in the last 2 months of 2008 as global trade slumped. A concern early in the year, inflation ebbed later on as the global and domestic economies slowed. The authorities have switched to expansionary fiscal and monetary policies to support growth, including a large fiscal stimulus. These steps will moderate the slowdown that is forecast for 2009, before growth picks up in 2010. Generating jobs and protecting the growing number of unemployed is a pressing issue.

Economic performance

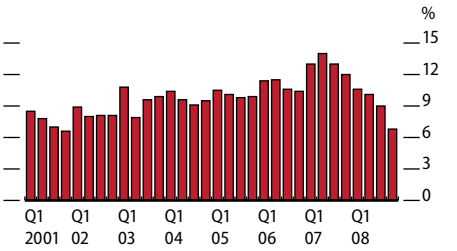
Growth pulled back from a rapid 13.0% in 2007 to 9.0% in 2008, the lowest rate since 2002, reflecting the combined effects of policy tightening to curb inflation, the global economic downturn, and natural disasters (severe snowstorms, floods, and May's Sichuan earthquake). GDP growth has decelerated since the second quarter of 2007, to 6.8% year on year in the fourth quarter of 2008 (Figure 3.9.1).

By sector, a sharp slowdown in industry, which makes up nearly 60% of GDP at constant prices, was the main cause of last year's overall deceleration: it slid to 9.3% from 14.7% in 2007. Industry still contributed an estimated 5.5 percentage points to total GDP growth. Services, accounting for 32% of GDP, followed a similar trend—its growth slowed to 9.5% from 13.8%. The contribution of services to GDP growth was about 3 percentage points. In contrast, agricultural production accelerated to 5.5% from 3.7%, but since agriculture now constitutes less than 10% of the economy, its contribution to total growth was just 0.5 percentage points (Figure 3.9.2).

On the demand side, investment continued to propel growth, contributing an estimated 3.9 percentage points. Consumption contributed an estimated 3.3 percentage points and net exports about 1.8 percentage points (Figure 3.9.3). On the basis of these estimates, the main cause of the GDP slowdown was a cooling in domestic demand that was exacerbated by weaknesses in exports as the year progressed.

Nevertheless, external demand slowed more and more as the global economic downturn deepened. Export growth remained robust in the first 3 quarters of the year as factories completed orders received earlier from abroad. However, in November and December 2008, merchandise exports turned down, by 2.2% and 2.8% (year on year) respectively, on a customs basis (Figure 3.9.4). This was the first such contraction in 7 years and the weakest pace since June 1999. Imports in those 2 months dropped by 18% and 21.3%, a consequence of weaker domestic and external demand and falling global commodity prices. As major industrialized economies

3.9.1 Quarterly GDP growth



Source: CEIC Data Company Ltd., downloaded 15 March 2009.

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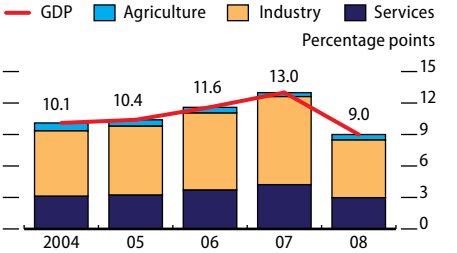
3.9.2 Contributions to growth (supply)



Sources: National Bureau of Statistics of China; staff estimates.

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This chapter was written by Jian Zhuang of the People's Republic of China Resident Mission, ADB, Beijing.

slowed further in 2009, exports contracted by 17.5% in January and by 25.7% in February. Mechanical and electrical products, textiles, and toys were particularly hard hit by shriveling external demand. But because imports fell much faster than exports, the trade surplus surged from about $315 billion in 2007 to $351 billion in 2008.

Steps that the Government took from the second half of 2007 to cool a booming property market included credit quotas, curbs on land supply for project developers, and tighter lending conditions for second-home buyers. Consequently, a falloff in property development last year contributed to a slowing of total real fixed asset investment growth from 20.2% in 2007 to 15.2% in 2008 (Figure 3.9.5).

The Government succeeded, perhaps more quickly than expected, in damping the property boom. Residential property sales went into a steep decline in 2008 and housing prices either stopped rising or fell in many cities. In December 2008, average prices for houses and apartments in 70 cities fell by 0.4% year on year, the first decline since July 2005, and the downtrend accelerated in the first 2 months of 2009. In addition, the contraction in property development depressed demand for building materials such as steel and cement (Figure 3.9.6), curtailing industrial output. Industrial investment held up well in 2008, expanding by 29%. However, slowing industrial output, falling profits, weaker exports, and overcapacity in some manufacturing industries strongly suggests that this rate of expansion cannot be sustained.

Consumption played an important role in maintaining GDP growth, although its contribution was slightly lower than in 2007 and less than that of investment. Growth in retail sales in real terms was around 15% (22% in nominal terms), speeding up from about 11% growth in 2007. Sales of motor vehicles rose by 25.3% in nominal terms and household appliances by 14.2%. This buoyant consumer demand was supported by rising incomes—urban incomes grew by about 8% in real terms last year—and slowing inflation, after a spurt early in the year.

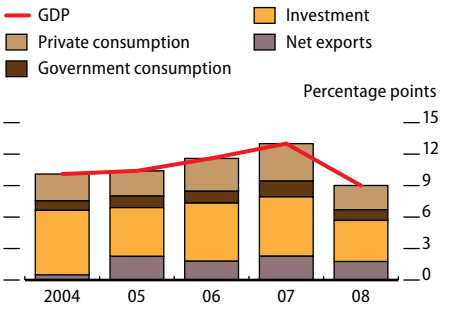
Inflation accelerated early in the year, driven by food. Once food prices stabilized, overall inflation was contained (Figure 3.9.7). On a year-on-year basis, inflation peaked in February 2008 at 8.7% and eased to 1.2% in December, resulting in a 5.9% average, the highest in 12 years. The deceleration continued into this year—the consumer price index fell by 1.6% in February 2009 from February 2008. Producer price inflation moderated during the second half of 2008, reflecting declines in global prices for oil and other commodities. After inflation pressures receded, the Government ended some price controls introduced in early 2008.

Since July 2005, the authorities have determined the exchange rate with reference to a basket of major currencies. Its overall appreciation against the basket has slowed. The exchange rate in real effective terms gained 1.6% in the fourth quarter of 2008, after appreciating by 10.1% in the previous 9 months.

Maintaining exchange rate stability has become part of the Government's macroeconomic policies to support GDP growth in the face of weakening exports and volatile global financial conditions. Pressure on the yuan to appreciate eased considerably as capital inflows slowed.

Boosted by the rise in the trade surplus, the current account surplus increased from $372 billion in 2007 to $440 billion in 2008, equivalent

3.9.3 Contributions to growth (demand)



Sources: National Bureau of Statistics of China; staff estimates.

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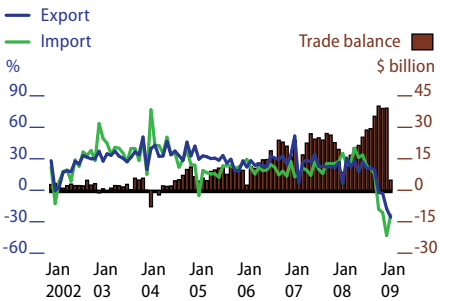
3.9.4 Trade indicators



Source: CEIC Data Company Ltd., downloaded 15 March 2009.

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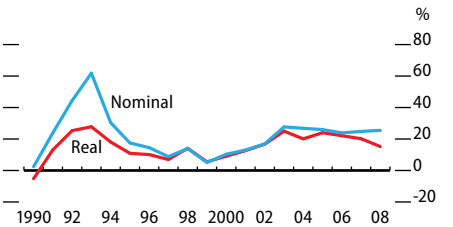
3.9.5 Fixed asset investment growth



Source: CEIC Data Company Ltd., downloaded 15 March 2009.

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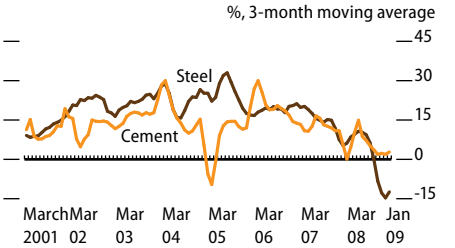
3.9.6 Steel and cement production



Source: CEIC Data Company Ltd., downloaded 15 March 2009.

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to 10.1% of GDP. Equity and debt inflows receded as the global financial crisis intensified and slowed the pace of the rise in official foreign exchange reserves, which still, however, ended the year $418 billion higher, at $1.95 trillion.

Domestic stock markets fell sharply in 2008, after soaring for most of 2006 and 2007. The Shanghai A-Share index plummeted by about 69% from its peak in October 2007 to December 2008 (Figure 3.9.8). The Government moved to stabilize stock markets with a 50% cut in the stamp duty on stock trading. It also prompted listed state-controlled companies to buy back their own shares.

The People's Bank of China, the central bank, tightened monetary policy through 2007 and well into 2008, when inflation and overheating were major concerns. It raised the reserve-requirement ratio for banks by 8.5 percentage points and its 1-year lending rate by 135 basis points between January 2007 and September 2008. These moves were coupled with guidance to banks to adopt informal credit quotas.

As the economy slowed and inflation eased in the fourth quarter of 2008, the central bank switched to an easing stance: it cut interest rates and reserve requirements and eliminated credit quotas. Between mid-September and end-December, it lowered the lending rate from 7.47% to 5.31%, the first reductions in 6 years, and the reserve-requirement ratio from 17.5% to 14.5% (Figure 3.9.9). Growth in M2 money supply picked up to 17.8% year on year in December and bank lending increased by 18.8% in that month. Both M2 and bank lending continued to accelerate in the first 2 months of 2009 (Figure 3.9.10).

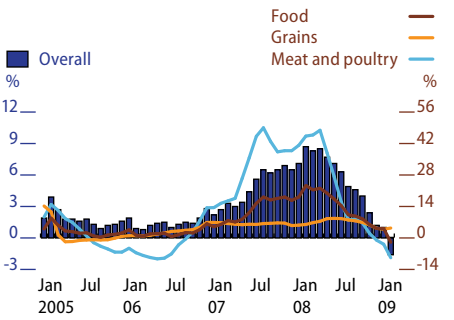
On the fiscal side, revenue growth was strong in the first half of 2008, but weakened late in the year owing to profit declines at state-owned enterprises and some tax concessions. Profits of state-owned enterprises administered by the central Government fell by 30% in 2008, the first decline on a yearly basis since 2002. As for tax breaks, the Government raised tax rebates to bolster exports, reduced taxes on house purchases, and cut the duty on stock trading in the second half of last year.

In view of the fast-deteriorating external environment, the Government in November announced a 2-year fiscal stimulus package costing CNY4 trillion ($586 billion, or 16% of 2007 nominal GDP) to shore up domestic demand. The package includes social and infrastructure spending, earthquake reconstruction, and subsidies to farms and industries (Box 3.9.1). Some of the spending on projects was already planned, and has been brought forward. The package will be funded by the central Government, local governments, banks, and state-owned enterprises. The central Government committed a total of CNY1.18 trillion for 2009 and 2010, of which CNY230 billion was disbursed in the fourth quarter of 2008 and the first quarter of 2009. Large increases in expenditures in the fourth quarter of 2008 resulted in an estimated full-year fiscal deficit of 0.4% of GDP, compared with a surplus of 0.6% in 2007.

Economic prospects

As the economic slowdown deepened, the Government continued to unveil new fiscal measures, including in January 2009 plans to spend

3.9.7 Monthly inflation



Source: CEIC Data Company Ltd., downloaded 15 March 2009.

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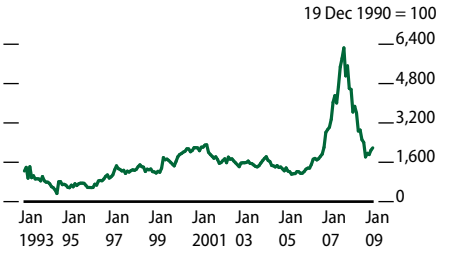
3.9.8 Shanghai A-share index



Source: CEIC Data Company Ltd., downloaded 15 March 2009.

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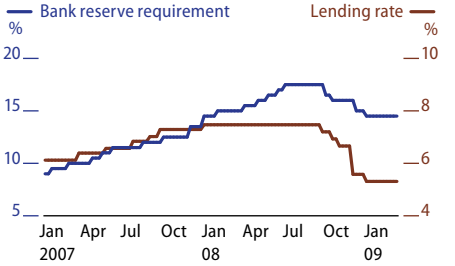
3.9.9 Reserve requirements and lending



Sources: CEIC Data Company Ltd., downloaded 15 March 2009; People's Bank of China.

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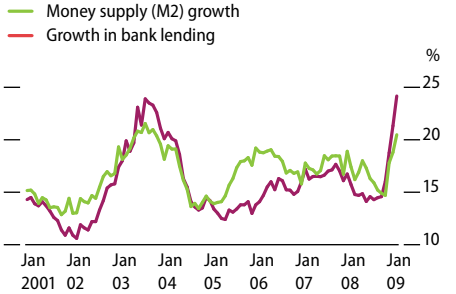
3.9.10 Monetary indicators



Source: CEIC Data Company Ltd., downloaded 15 March 2009.

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3.9.1 The November 2008 fiscal stimulus package and its financing

The Government selected 10 areas for extra spending to provide a boost to the economy in 2009 and 2010.

- Housing—More affordable and low-rent housing, acceleration of slum demolition, launch of a pilot program to rebuild rural homes, and encouragement to nomads to move into permanent housing.
- Rural infrastructure—Improvement of roads and power grids in the countryside, and water supply projects, including a huge project to divert water from the south to the north. Additional efforts to reduce poverty.
- Transport—More rail links and routes for transporting coal. New airports in the west.
- Health and education—Hospitals in smaller towns and cities. More schools in the western and central regions, and for children with special needs countrywide.
- Environment—Focus on sewage and garbage treatment facilities and on preventing water pollution. Accelerated green belt and natural forest–planting programs. Additional energy-conservation initiatives and pollution-control projects.
- Industry—Further subsidies for high-tech and service industries.
- Earthquake reconstruction—Extra funding to rebuild areas damaged by the Sichuan earthquake.
- Wealth creation—Increased grain purchases and farm subsidies to raise rural incomes. A boost in pension funds for a wide range of workers. More allowances for low-income city dwellers.
- Tax—Reforms to value-added tax, effective 1 January 2009. Reduction in corporate tax burden of CNY120 billion ($18 billion).
- Finance—Removal of loan quotas and ceilings for lenders. Increased bank credit for rural areas, small businesses, and companies involved in technology, iron, and cement.

On top of the central Government's pledge of CNY1.18 trillion for the stimulus package, the State Council will allow local governments to issue CNY200 billion in bonds through the Ministry of Finance (local governments are not usually allowed to issue bonds).

Other funding sources include long-term bank loans and corporate bonds issued by state-owned enterprises. If the entire CNY4 trillion were to be financed by debt issuance, total national debt would increase to 28% of GDP, which is still relatively moderate.

CNY850 billion during 2009–2011 to improve medical care, in February 2009 a planned CNY600 billion for research and technical innovation, and (the same month) a subsidy for farmers nationwide to buy household appliances. Specific industrial policies designed to support the adjustment and revival of key industries such as steel, automobiles, and textiles are being unfolded. Moreover, the monetary authorities have scope for more accommodative policies in view of low inflation at the start of 2009.

Still, the focus on public investment in the stimulus package suggests that it will take some months to gain traction. As a result, the economy is not expected to pick up until the second half of 2009, when more public investment is implemented. Growth should edge higher in 2010.

The dismal outlook for external demand suggests that merchandise exports are likely to fall by about 4% in 2009, before rebounding to 8% growth in 2010. Lower global oil prices and softer domestic demand for raw materials will reduce merchandise imports this year by about 7%. Next year, imports are forecast to rise by 10%. The merchandise trade surplus is expected to continue to rise. Weak global economic growth will reduce tourism receipts and contribute to a widening in the services trade deficit.

Capital inflows are likely to remain suppressed by the global financial crisis. The surplus on the income account will likely be maintained, reflecting earnings from the country's foreign exchange reserves and investments. In view of these developments, the current account is forecast to record substantial surpluses (8.4% of GDP in 2009 and 7.8% in 2010), coming down a little from just over 10% in the past 2 years. On this basis, foreign exchange reserves will rise to $2.2 trillion in 2009 and to $2.5 trillion in 2010.

3.9.1 Selected economic indicators (%)

	2009	2010
GDP growth	7.0	8.0
Inflation	0.8	1.0
Current account balance (share of GDP)	8.4	7.8

Source: Staff estimates.

Government investment will get a boost from the fiscal measures and public consumption (about 30% of total consumption) will likely expand rapidly as the Government implements the package. The contribution to GDP growth of this investment and consumption is expected to be 3–4 percentage points in 2009, compared with less than 3 points in 2008.

However, private sector investment is forecast to slow this year. Property development will likely be sluggish for as long as the housing market remains soft. The poor export outlook will curb investment in export-oriented industries, especially textiles, garments, footwear, and toys. Investment in domestic demand–driven industries should hold up relatively well, helped by the value-added tax change that reduces their tax costs. Still, profits in these industries too have been squeezed and some of them have excess production capacity.

A survey by the central bank suggests that the sharp slowdown in growth late in 2008 was in part a reflection of producers' inventory destocking, prompted by the slump in exports and in prices of many commodities. In the context of the Government's current policies to spur the economy and to revive major industries, producers are likely to end destocking and start to increase inventories in the second quarter of 2009.

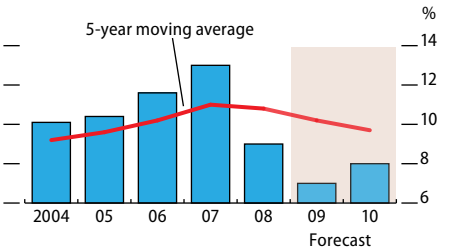
In contrast, private consumption growth is likely to remain buoyant at around 8–9% this year and next. The low level of inflation will benefit consumption, as will both the subsidy for people in rural areas to buy household appliances and some of the stimulus package measures. Furthermore, the threshold for levying personal income tax might be raised this year, adding to disposable incomes. These positive factors will be offset to some degree by a weaker labor market. Growth in real retail sales grew at a solid rate in the first 2 months of 2009.

Based on these considerations, GDP growth is forecast at 7.0% in 2009. It should pick up to 8.0% in 2010 (Figure 3.9.11) as the global economy starts to recover, underpinned by a full year's impact of the domestic policy measures. Last year's high first-quarter base means that the year-on-year increase in GDP will probably ease to about 6% in the first 3 months of 2009, from 6.8% in the fourth quarter of 2008. Growth is expected to edge up from there, to about 8% in the second half of 2009.

Inflation is expected to average less than 1% in 2009 (Figure 3.9.12), suppressed by slackness in the economy, expanding supplies of food, and declining rents. Lower average prices for oil and other commodities will put downward pressure on producer prices, although the Government might raise administered utility charges as part of its reforms of energy pricing.

Downside risks to these forecasts stem from uncertainties in the global economy and a deeper than expected domestic property slump. On the upside, further domestic stimulus policies could spark an earlier recovery in the property market and faster growth in private sector investment.

3.9.11 GDP growth



Sources: National Bureau of Statistics of China; staff estimates.

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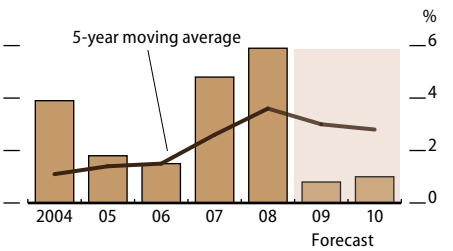
3.9.12 Inflation



Sources: National Bureau of Statistics of China; staff estimates.

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Development challenges

Unemployment is the most pressing issue. It worsened last year when external demand slumped, leading to layoffs in export-oriented industries. There have been more job losses in both the private and public sectors since then. The Government estimated in February 2009 that

about 20 million migrant workers of the total of 130 million had at that date lost their jobs because of the economic slowdown. In December 2008, the Chinese Academy of Social Sciences, an academic research organization, estimated that 1.5 million of 5.6 million graduates from colleges last year could not find jobs by year-end. The Academy estimated that the total urban unemployment rate was 9.4% at end-2008, or more than twice the official urban unemployment figure of 4.2%, which excludes most migrant workers.

Investment projects in the stimulus package will generate jobs, but not enough to absorb the growing labor surplus. For one thing, infrastructure projects are generally less labor intensive than export-oriented manufacturing. Certainly, a rebound in economic growth can create large numbers of jobs—13.6 million nonfarm jobs were created each year from 2000 and 2007 when GDP growth averaged 10.2%. However, employment generation on this scale will be more difficult in the future because employment elasticity—the rate of employment growth to GDP growth—has declined in recent years.

Rebalancing the economic structure away from an emphasis on investment- and export-led growth and toward private consumption as a growth driver remains a challenge (Box 3.9.2). A better social safety net may well encourage private consumption by reducing people's precautionary saving (for education, medical care, and retirement). Maintaining the trend toward higher incomes is also important in this regard, as is addressing income inequality. The income ratio between urban and rural residents, for example, widened from 2.9:1 in 2001 to 3.31:1 in 2008 (Figure 3.9.13).

Pressing ahead with certain policies that have been announced but not yet implemented would also facilitate rebalancing. This means realizing reforms concerning rural land-use rights, while ensuring transparency and mechanisms to prevent exploitation of rural households, and finalizing a draft health reform package and a long-term plan for education.

At this time of rising unemployment, it will also be important to strengthen social protection programs, particularly for migrant workers who lose their jobs. Many of them are returning to the countryside where there is little work. Some have been offered assistance by the Government, such as vocational training and one-time cost-of-living subsidies.

The fall in global energy prices provides an opportunity to make more progress on reforming domestic pricing of energy and natural resources. These prices are generally much lower than world levels, reducing incentives to achieve energy efficiencies or to reduce emissions of major pollutants. Reforms have been implemented on the pricing and taxing of gasoline and diesel; the next step should be accelerating the pricing of natural gas, water, and electricity.

Box 3.9.2 Rebalancing the economy

The Government's midterm evaluation of implementation of the 11th Five-Year Plan (2006–2010), which set goals for rebalancing the economy, showed that progress is lagging in several areas.

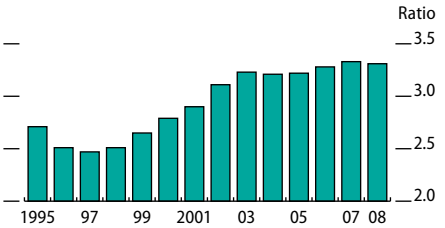
Among four key structural indicators used to measure rebalancing—share of the services sector's value added to GDP, share of employment in the services sector, share of research and development spending in GDP, and urbanization rate—only the urbanization rate met the target. Two other targets—on energy efficiency and pollution reduction—were not met.

Given that the CNY4 trillion stimulus package concentrates on investment projects rather than private consumption, the package is unlikely to help shift growth from an investment-led pattern to one driven more by consumption.

The economy has significant room to expand consumption. Household consumption as a share of GDP was 36.3% in 2007, one of the lowest ratios in the world.

There is much potential for greater public consumption, too, in view of the strong fiscal situation and low public debt. The Government has set up several social development programs such as *dibao* (a minimum living-standards guarantee) and basic health insurance for eligible urban and rural households whose annual incomes are below the *dibao* level.

3.9.13 Urban–rural income ratio



Sources: National Bureau of Statistics of China; staff estimates.

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Hong Kong, China

Growth in this open economy was dealt a heavy blow toward the end of 2008 by the global financial crisis and trade slump. The important financial and real estate services industries contracted in the second half of 2008. For the year, consumption barely grew and fixed investment flattened. In 2009, exports are forecast to fall and both private consumption and investment will likely shrink. GDP is expected to contract, before growth resumes in 2010. Inflation has decelerated and is expected to remain low over the forecast period.

Economic performance

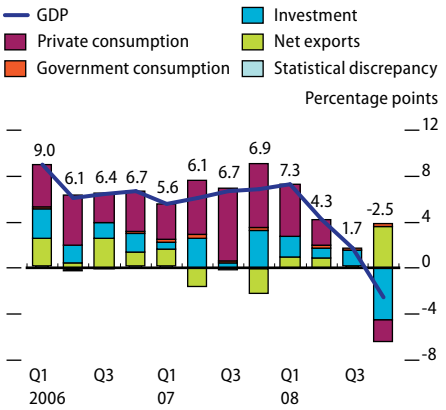
The economy opened 2008 with robust growth of 7.3% in the first quarter, year on year, slowed sharply in the second and third quarters, then contracted by 2.5% in the fourth (Figure 3.10.1). For the full year, growth decelerated to 2.5%, from 7.2% on average over 2004–2007. It was undermined by the global financial crisis, given the importance of financial services to this economy, and further eroded late in the year by the slump in world trade. Hong Kong, China is one of the most open economies in the world—the ratio of exports and imports to GDP was about 410% (including reexports) in 2008. The deteriorating external conditions severely dented consumer and business confidence.

Private consumption grew by a meager 1.8% in 2008, compared with buoyant growth of 8.5% in 2007. Spending was curtailed by the increasingly gloomy international outlook and its deleterious effect on employment and personal wealth. Unemployment rose from 3.4% in the first quarter to 4.1% in the fourth. As for asset markets, the share price index plunged by 48% in 2008 (Figure 3.10.2) and property prices turned down in the second half (Figure 3.10.3). Moreover, growth in visitor arrivals slowed to 4.7% from 11.6% in 2007, and that in the volume of retail sales slowed by about half, to 5.0%. Spending on services edged up by less than 1%. Consumption contributed about half of total GDP growth, much less than in 2007.

The deterioration in external and domestic demand caused businesses to cut back on investment in machinery and equipment in the fourth quarter. Fixed investment overall was flat in 2008 (it grew by 3.4% in 2007). When adjusted for changes in inventories, total investment contracted by 1.1% and subtracted 0.3 percentage points from GDP growth.

Growth in real exports of goods and services slowed, especially in the second half of the year when the global downturn intensified. For the year, real exports decelerated to 2.7% from 8.3% growth in 2007. Growth in real imports pulled back even faster than that for exports, with the

3.10.1 Contributions to growth (demand)



Source: Census and Statistics Department, available: http://www.censtatd.gov.hk/, downloaded 2 March 2009.

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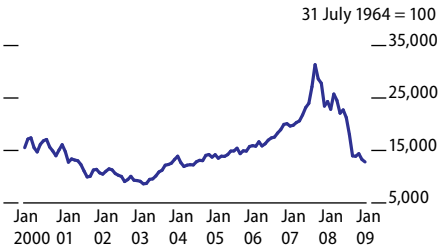
3.10.2 Hang Seng index



Source: CEIC Data Company, Ltd., downloaded 15 March 2009.

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This chapter was written by Juthathip Jongwanich of the Economics and Research Department, ADB, Manila.

result that net exports of goods and services contributed 1.5 percentage points to total GDP growth.

Reexports, mainly originating from the People's Republic of China (PRC) and accounting for 97% of total merchandise exports, rose by about 6% in nominal US dollar terms, the weakest result since 2001. Domestic merchandise exports fell. Financial services exports slowed as international capital market activity shriveled. Total services exports grew by 9.2% in nominal terms, another area whose growth slowed by around half. Still, a large surplus in services trade and a surplus in the income account more than compensated for a widening of the merchandise trade deficit (Figure 3.10.4). The current account surplus rose to the equivalent of 14.2% of GDP. After accounting for investment inflows, the overall balance of payments registered a surplus of 15.7% of GDP (Figure 3.10.5).

Services account for virtually all of GDP, and sector growth slowed to 2.5%, also the weakest since 2001. Wholesale and retail trading and transport and storage subsectors contracted in the fourth quarter, year on year. The important finance, insurance, and real estate subsectors were hit harder: they contracted in both the third and fourth quarters. Nevertheless, the services sector was the only one to contribute to GDP growth. Production of the small manufacturing and agricultural sectors fell in 2008.

Slower economic growth and increases in government spending in FY2008 (ended 31 March 2009) resulted in a fiscal deficit estimated at 0.3% of GDP, compared with a surplus of more than 7% in FY2007. Fiscal concessions, largely aimed at cushioning the impact of rising prices in the first half, included temporary increases in welfare benefits, a one-time grant to subsidize household electricity costs, income tax rebates, and a waiver on property tax.

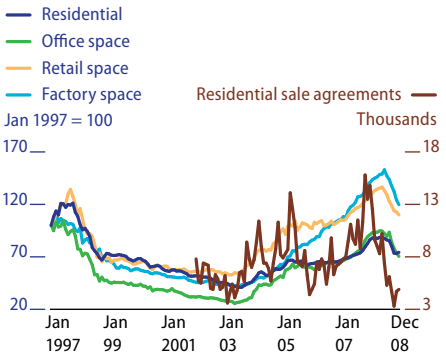
Inflation accelerated to 6.3% through July, driven by higher prices for imported food and by fuel and rent increases (Figure 3.10.6). As global food and fuel prices declined and domestic demand weakened during the second half, inflation moderated to 2.1% by December. Year-average inflation was 4.3%. After adjusting for the fiscal concessions, which subdued some prices, underlying inflation was 5.6%.

Given that the United States (US) and Hong Kong dollars are linked, interest rates in this economy broadly follow those in the US. The Hong Kong Monetary Authority lowered the base rate under its discount window throughout 2008, to 0.5% at year-end. Bank lending rates in real terms declined in the first half, but rose in the second half as inflation moderated, leaving them unchanged by year-end.

Economic prospects

Contracting economies in the eurozone, Japan, and US, coupled with the continuing global financial crisis, are particularly bad news for this trade- and services-dependent economy. The slowdown in the PRC—with which Hong Kong, China has extensive trade, logistics, and services links—adds further gloom to the outlook. The forecasts assume that the yuan will appreciate slightly against the US dollar and that the Hong Kong dollar's link with the US dollar will be maintained.

3.10.3 Property price indexes and number of transactions



Source: Rating and Valuation Department, available: http://www.rvd.gov.hk, downloaded 15 March 2009.

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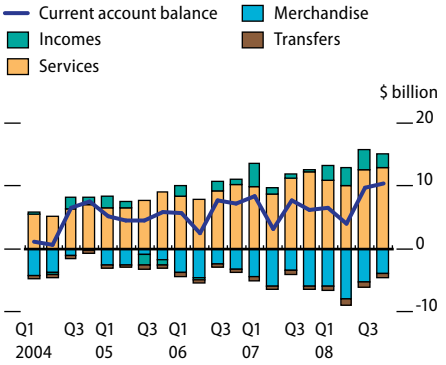
3.10.4 Current account components



Source: Census and Statistics Department, available: http://www.censtatd.gov.hk/, downloaded 23 March 2009; Hong Kong Monetary Authority.

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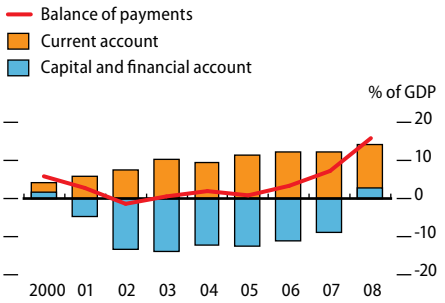
3.10.5 Balance-of-payments indicators



Sources: Census and Statistics Department, available: http://www.censtatd.gov.hk/, downloaded 23 March 2009; Hong Kong Monetary Authority.

Click here for figure data

Slack external demand will further weaken the labor market in 2009, pushing up unemployment and suppressing consumer confidence. Slower growth in tourist arrivals and the softening property market will also damp consumer spending. Investment will decline as a result of the somber outlook for both exports and demand for new buildings. Furthermore, banks have generally adopted a more guarded approach to lending. Both consumption and investment are forecast to contract this year. An expansionary fiscal stance (Box 3.10.1) will provide some support for domestic demand. So should low interest rates. But these positive influences cannot neutralize the powerful negative forces.

Real exports of goods and services are forecast to weaken in 2009 compared with 2008. As a services-based economy, the prolonged global financial crisis and slump in both trade and tourism will further erode services exports, while merchandise reexports will remain sluggish. Imports in real terms will contract, given the decline in domestic demand.

On balance, GDP is forecast to fall by 2.0% in 2009, the first contraction since the economy shrank by 6.0% in 1998 during the Asian financial crisis. In 2010, growth is expected to resume at about 3% (Figure 3.10.7) as world trade picks up and financial markets rally. Growth in the PRC is projected to pick up by about 1 percentage point in 2010, which would support a recovery in Hong Kong, China. These influences are likely to feed through to and boost consumer and business confidence next year.

Merchandise exports and imports in the first 2 months of 2009 slumped by 22% from prior-year levels on a customs basis. This rate of decline is not expected to continue through the year: exports for the whole year are projected to drop by about 5%, subject to substantial downside risks because of the uncertain global prospects. Imports will fall faster than exports owing to the sluggish domestic demand and lower prices of imported oil and other commodities compared with 2008. The merchandise trade deficit will likely narrow, but the services trade surplus will fall, reflecting weaknesses in financial services and tourism. The income account is expected to be in deficit as dividends from overseas investments decline in the context of lower global corporate profits. Consequently, the current account surplus will likely decline, but remain substantial at 9–10% of GDP in the forecast period.

Inflation pulled back to average 2.0% in the first 2 months of 2009. It is expected to be about 1.5% for the whole year, a result of subsiding domestic demand and lower prices for imported fuel and food than in 2008. Against this, some fiscal concessions, such as waivers on public housing rents and grants to subsidize household electricity bills will expire this year so that the consumer price index will not fully reflect the weakness in domestic demand. In 2010, inflation is expected to edge higher as the recovery gets underway.

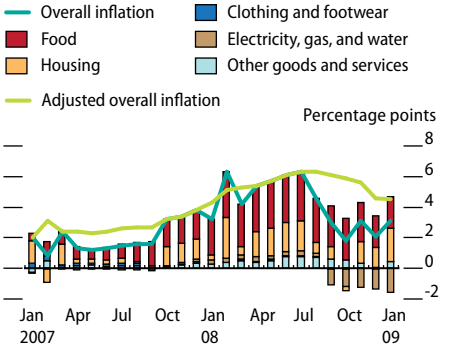
Risks to these forecasts stem mainly from external influences and are predominantly on the downside. Further jolts to the international financial system would quickly spill into domestic financial markets, causing further contraction in financial services, steeper declines in equity and property prices, and greater caution in lending. A deeper than expected slump in global trade would curtail growth in the PRC, with spillover effects to Hong Kong, China.

3.10.1 Selected economic indicators (%)

	2009	2010
GDP growth	-2.0	3.0
Inflation	1.5	2.0
Current account balance (share of GDP)	9.0	10.0

Source: Staff estimates.

3.10.6 Monthly inflation and components

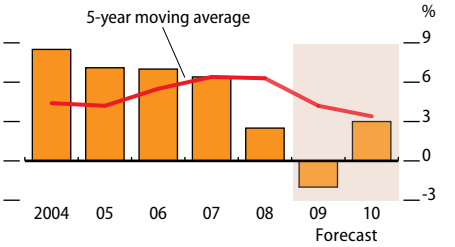


Note: Adjusted overall inflation refers to the rate after the effects of the Government's one-time relief measures are removed.

Sources: CEIC Data Company Ltd., downloaded 15 March 2009; Census and Statistics Department, *Monthly Report on the Consumer Price Index, January 2009*, Table B, available: http://www.censtatd.gov.hk.

Click here for figure data

3.10.7 GDP growth



Sources: Census and Statistics Department, available: http://www.censtatd.gov.hk/, downloaded 2 March 2009; staff estimates.

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3.10.1 Global financial crisis and the economy

The Government and the Hong Kong Monetary Authority (HKMA) have taken a range of policy measures to support the economy and its financial institutions since mid-September 2008, when the global financial crisis intensified.

Monetary and financial policies

HKMA injected HK$179 billion (US$23 billion) into the banking system during September–December through market operations involving the purchase of US dollars for Hong Kong dollars, to address a squeeze in the interbank market and rising demand for Hong Kong dollars.

The monetary authority expanded acceptable collateral for borrowing under the discount window to include US Treasury securities, while maturities of liquidity assistance provided through its discount window were extended to up to 3 months. It reduced the base rate to 50 basis points above the prevailing US Federal Funds target rate and delinked the base rate from interbank rates. It took these temporary measures to enhance liquidity in the banking system.

The Government announced a blanket guarantee of all customer deposits held with all authorized institutions in Hong Kong, China, to end-2010. It also unveiled a facility to provide capital to locally incorporated banks, if they needed it.

HKMA offered banks foreign exchange swaps and a term lending facility to provide Hong Kong dollar liquidity against approved collateral for maturities of up to 3 months, until March 2009.

The People's Bank of China and HKMA signed an agreement for a CNY200 billion (US$29 billion) currency swap facility to provide short-term liquidity support to operations of Hong Kong banks in the PRC and vice versa.

Fiscal policies

The Government announced a HK$100 billion (US$12.8 billion) package of loan guarantees for small and medium-sized firms in December 2008.

A package of measures was outlined by the governments of the PRC and Hong Kong, China aimed at increasing cooperation on trade, financial, and infrastructure matters.

The budget unveiled in February targets a deficit equivalent to 2.4% of GDP for FY2009 and a deficit of 1.5% of GDP in FY2010. The budget includes spending of HK$1.6 billion aimed at generating 62,000 jobs and internships over 3 years, HK$39.3 billion in outlays on infrastructure, and several social support measures.

Economic and financial indicators

Key indicators of economic and financial health have generally strengthened in recent years. The current account surplus exceeded 10% of GDP and gross international reserves increased to US$182.5 billion at end-2008. Fiscal reserves also are substantial. The real exchange rate has closely tracked the long-run equilibrium real exchange rate, which implies that the Hong Kong dollar is valued broadly in line with economic fundamentals.

In the financial sector, the loan-to-deposit ratio in 2008 at about 54% indicates that bank funding is mainly through deposits rather than external sources. The capital-adequacy ratio of locally incorporated banks increased and the nonperforming loan ratio decreased in 2008. Some banks incurred losses on US "toxic" assets, but total exposure in relation to banking system assets is low.

There are concerns that banks will face pressure on profits from declining margins between funding costs and loan interest rates, as well as from reduced fee income, as a consequence of the slump in share offerings and in wealth management activity. As in other economies, nonperforming loans are likely to rise during the economic slowdown.

Economic and financial indicators

	2008
Fiscal reserves (% of GDP)	31.2
Loan–deposit ratio	54.0
Nonperforming loans (% of total)	1.2
Capital-adequacy ratio	14.8
Current account (% of GDP)	14.2
Gross international reserves (months of retained imports)	22.5

Sources: CEIC Data Company Ltd., downloaded 27 February 2009; staff estimates.

Development challenges

Hong Kong, China has extensive investment and trade with the Pearl River delta area of the PRC's Guangdong province. The delta is a major low-cost manufacturing and export base for products such as electronics, toys, clothing, and textiles. Investors from Hong Kong, China account for over 70% of the cumulative foreign direct investment there. Furthermore,

Hong Kong, China has leveraged its comparative advantages to provide services such as logistics, shipping, and finance to firms in the delta.

Since global trade slumped in the second half of 2008, orders for products from factories in the delta fell sharply, and layoffs have been widespread. Even after world trade picks up, many low-end manufacturers are expected to relocate to other provinces or to other countries where labor and land costs are lower. The PRC Government, acting to bolster confidence, announced ambitious plans in December to deepen cooperation between Guangdong; Hong Kong, China; and Macau, China in an effort to achieve closer integration and to transform the delta into a center for high-technology industries and services. Early priorities are to extend road and rail links and accelerate construction of a long-planned US$5.5 billion bridge between the three places.

For Hong Kong, China to gain the full benefits of closer integration, it needs to further improve its infrastructure links with Guangdong and reduce bottlenecks in customs clearance. Also, it will be important to boost investment in tertiary education to build a larger base of professionals who can operate in both economies. Joint efforts to reduce air pollution caused by rapid development in both economies should be intensified. At the same time, Hong Kong, China needs to safeguard the reputation of its high-quality institutions that make it a predictable and stable services center.

Republic of Korea

Rocked by slumping external demand, the economy slowed sharply in the second half of 2008. The worsening global outlook combined with soft domestic demand to deliver the slowest GDP growth since the Asian financial crisis of 1997–98. Fiscal stimulus will to some extent offset the weakness in aggregate demand in 2009, but the economy will likely contract before growth resumes in 2010. A key longer-term policy challenge is to smooth domestic expenditure so as to cushion the impact of external fluctuations.

Economic performance

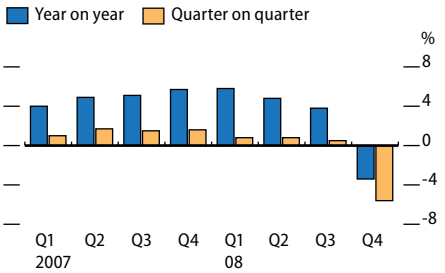
Severely affected by the global downturn and weakening domestic demand, GDP growth fell to 2.5% in the Republic of Korea (hereafter Korea) in 2008, well below the 5.0% of 2007 and the 2003–2007 average of 4.4%. The pattern of growth throughout the year mirrored the progressive intensification of the global financial crisis and the consequent deterioration of the world economy. GDP growth accelerated by a solid 5.8% in the first quarter, but then decelerated until output contracted by 3.4% in the fourth quarter on a year-on-year basis (Figure 3.11.1). Notwithstanding the softness of external demand, net exports still accounted for over 90% of total GDP growth, reflecting the even greater fragility of domestic demand. While the global downturn was the immediate catalyst of Korea's slowdown, sluggish private consumption and investment have amplified its effects.

Merchandise export growth (in nominal US dollar terms) held up well in the first 3 quarters of the year, before shipments contracted outright in the fourth, when the impact of the global downturn hit Korean exporters with full force (Figure 3.11.2). All major export products faced weaker demand in all major markets. Given the importance of the G3—United States (US), European Union (EU), and Japan—as export markets, the synchronized G3 recession has been a powerful drag on exports. Import demand from the People's Republic of China (PRC) and other major emerging markets has also cooled rapidly, and offers little respite from the collapse of G3 demand.

Merchandise import growth accelerated in the first 3 quarters, before contracting in the fourth. For the full year, the trade surplus fell sharply and the current accounted moved into deficit (estimated at a modest 0.7% of GDP) for the first time since 1997. In the fourth quarter, the current account shifted back into positive territory owing to import compression and the decline in oil and other commodity prices. Reflecting domestic financial institutions' repayment of foreign loans, the financial account deficit ballooned to $51 billion.

Private consumption rose by an anemic 0.5% in 2008, sharply down from a healthy 4.5% in 2007. As with exports, private consumption decelerated over the course of the year (Figure 3.11.3) and surveys pointed

3.11.1 GDP growth



Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 9 March 2009.

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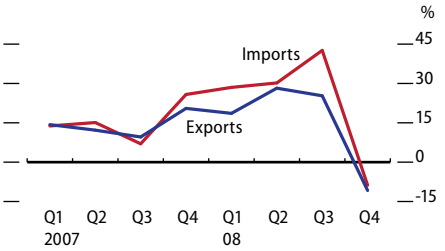
3.11.2 Merchandise trade growth



Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 6 March 2009.

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This chapter was written by Donghyun Park of the Economics and Research Department, ADB, Manila.

to a steady deterioration of consumer sentiment (Figure 3.11.4). The impact of worsening consumer sentiment was most evident in stagnant sales of automobiles and household appliances. Inflation pressures in the first half of the year, together with a sluggish job market, dented consumption. The plunging stock market, which fell by 39.3% in local currency terms and 64.9% in US dollar terms, and depreciation of the won (Box 3.11.1) also damped consumption.

Fixed capital investment fell by 1.9% in 2008, compared with robust growth of 4.0% in 2007. Equipment investment, which plunged by 14% in the fourth quarter, fell by 2% for the year. Construction investment was in negative territory throughout the year, and fell by 2.7%. A surge in the price of imported capital goods and hence in the equipment investment deflator contributed to the decline of equipment investment in real terms. This drop was most pronounced in the information and communications technology industry. Business confidence fell throughout the year, with the decline accelerating in the fourth quarter. Also weighing on corporate investment, the average capacity utilization rate of manufacturing fell below 70% (Figure 3.11.5) for the first time in 10 years. The slump in construction investment was especially evident in residential construction, reflecting a weak housing market.

Although growth replaced inflation as the main macroeconomic concern as 2008 progressed, price pressures were also problematic. Year-average inflation accelerated to 4.7%, above the Bank of Korea's 2.5–3.5% target band. The weaker won and higher prices for oil and other commodities pushed up inflation until the fourth quarter, when pressures abated in response to the oil price collapse and slowing economy. In August, when inflation was a major concern, the Bank of Korea raised its policy interest rate by 0.25 percentage points to 5.25%. As the economy faltered and inflation eased, it switched to rapidly lowering the policy rate, in five steps to 2.0% by February this year.

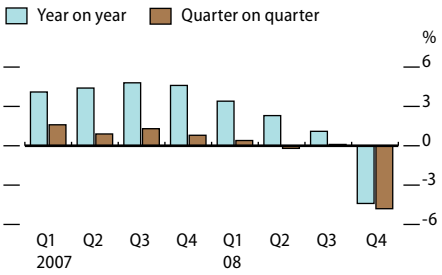
Reflecting the poor economic performance, labor market conditions deteriorated. Growth of employment was about half the increase in 2007. A surge in the number of workers who dropped out of the labor force contained the unemployment rate at 3.2%.

Economic prospects

The deceleration of the economy, which gathered pace in the fourth quarter of 2008, is expected to continue in the first half of 2009 and to level out in the second half. Early data on indicators such as exports, manufacturing output, and retail sales point to an intensification of output contraction in the first quarter of this year. The events of 2008 show that growth of the Korean economy, despite its large size, remains highly dependent on external demand. The gloomy global economic outlook for 2009 will therefore weigh on the country's export and growth prospects. The uncertainty surrounding the global downturn translates into a great deal of uncertainty for the country's performance, but the combination of a much-worsened global outlook and feeble domestic demand clearly point to a very difficult year.

Due to the synchronized slowdown of demand both from industrialized countries and from emerging markets, exports will fall in

3.11.3 Private consumption growth



Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 9 March 2009.

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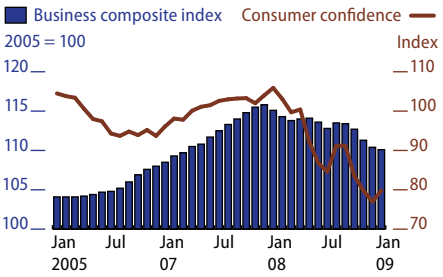
3.11.4 Confidence indicators



Note: Data from January 2005–August 2008 refer to the Consumer Expectations Index, while values after that were derived using the Composite Consumer Sentiment Index.

Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 9 March 2009.

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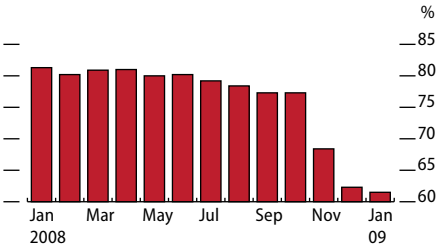
3.11.5 Capacity utilization ratio



Source: Bank of Korea.

Click here for figure data

3.11.1 Selected economic indicators (%)

	2009	2010
GDP growth	-3.0	4.0
Inflation	2.0	2.0
Current account balance (share of GDP)	1.9	1.4

Source: Staff estimates.

3.11.1 The risks of capital account liberalization: Lessons from Korea's financial instability

During 2008, Korea suffered an unusually high degree of financial instability relative to other Asian countries. The instability reached its peak in October, when the Korean won fell sharply (Box figure 1) and the stock market plunged by one third. There was even speculation of a repeat of the Asian crisis, which had wrought havoc on the economy. The financial stress was puzzling in light of the country's relatively strong macroeconomic fundamentals—current account, fiscal, and international reserves—and microeconomic fundamentals, such as strong balance sheets at financial institutions and corporations. Other Asian countries with comparable fundamentals were largely spared such financial turbulence.

1 Exchange rate

Source: CEIC Data Company Ltd., downloaded 9 March 2009.

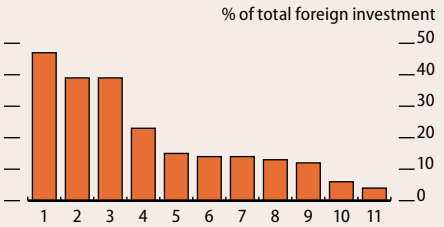
Click here for figure data

The most likely answer lies in Korea's exceptionally high degree of capital account liberalization. For example, there are almost no restrictions on foreign residents' purchase and sale of domestic equities, or domestic financial institutions' foreign borrowing. The large exposure of Korean banks to short-term foreign loans arose largely from their taking counterparty positions to the purchases of forward exchange contracts by Korean shipbuilders keen to hedge themselves against exchange rate risk. The rollover rate on those loans fell sharply as a result of the global credit crunch and the consequent repayment pressures precipitated a plunge in the won in October.

The share of equity investment in total foreign investment is the third highest among 30 Organisation for Economic Co-operation and Development economies, at 39.0% (Box figure 2). Hedge funds and other foreign residents withdrew from Korean equities to reinforce their balance sheets at home as the global financial crisis intensified. Total net sales of equities by foreign residents exceeded W43 trillion during 2008. Those sales were the main drivers of the year-long plunge of the equity market and contributed to the won plunge in October.

Government actions, most notably currency swaps between the Bank of Korea and the central banks of the US, Japan, and the People's Republic of China, brought a measure of stability to the foreign exchange market in late 2008 and early 2009. However, the won fell sharply again in late February and early March.

2 Equity investment, selected OECD countries



1 = Luxembourg; 2 = Japan; 3 = Rep. of Korea; 4 = Australia; 5 = United States; 6 = Germany; 7 = France; 8 = Spain; 9 = United Kingdom; 10 = Canada; 11 = Italy.

Source: Organisation for Economic Co-operation and Development, as cited in Samsung Economic Research Institute, CEO Forum, 24 December 2008.

Click here for figure data

What has happened in Korea suggests the need for a cautious and gradual approach for those developing countries embarking on capital account liberalization. Countries that are more open to cross-border capital flows will suffer disproportionately when foreign residents withdraw their funds from the local financial markets. Such risks are exacerbated if domestic banks are heavily exposed to short-term foreign loans.

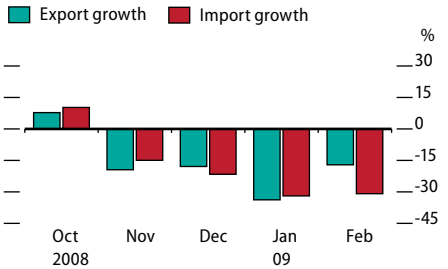
Although liberalization provides substantial benefits, for example by giving greater access to foreign savings, those benefits have to be weighed against the risk of financial contagion from financial center countries. This risk tends to be amplified during times of heightened global financial stress.

2009 for the first time since 2001. Worryingly, the contraction of exports that began in the last 2 months of 2008 gathered pace during the first 2 months of this year. Exports plunged by 33.8% in January from the same month in the previous year, and by 17.1% in February (Figure 3.11.6). Exports are expected to fall until at least the third quarter of 2009, and for the whole year they will likely be down by 15% relative to 2008.

Demand for Korea's major export items tends to be highly sensitive to the global business cycle. The recession and lower disposable incomes in the G3 presage poor sales there of the automobiles, electronics, and other durable goods that account for much of the country's consumer goods exports. The same goes for capital goods, which usually account for almost half of exports.

Global excess capacity in various industries, particularly information

3.11.6 Merchandise trade



Source: CEIC Data Company Ltd., downloaded 9 March 2009.

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and communications technology, has combined with softening demand to discourage investment. Exports of petroleum products, chemicals, steel products, and machinery, which grew rapidly in recent years, will also be hard hit. Export unit prices are projected to fall for product groups whose prices are heavily influenced by the price of oil and other raw materials, such as petroleum products, petrochemicals, and steel. The fall in export unit prices of such major product groups will hit the total value of exports. Increasing protectionism might further dent export prospects, since protectionist pressures are most pronounced in major export markets and product groups.

The current account balance is expected to return to a surplus (Figure 3.11.7), of more than $10 billion in 2009, with trade surpluses for both goods and services. Weak domestic demand will cut imports, producing a trade surplus, and curtail foreign travel, reversing the chronic deficit in services.

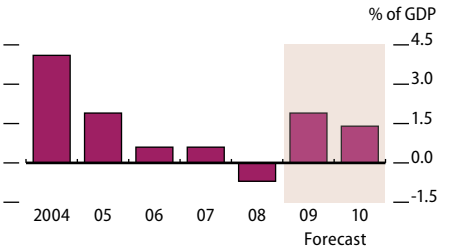
Although the economic contraction will be driven by the weakness of external demand, domestic demand is also projected to decline, foreshadowing a broad-based recession. The simultaneous softening of external and domestic demand began in the fourth quarter of 2008 and will persist until at least the third quarter of 2009.

Private consumption is expected to contract by about 4% in the first half and about 2% in the second. The unfolding recession will constrain job creation and wage growth, and thus crimp the purchasing power of consumers. It will also give impetus to industrial restructuring, especially in shipbuilding and construction, and the associated layoffs will drag down spending. So will the decline in asset prices, especially the plunge in stock prices last year. Korea's ratio of household debt to GDP stands at about 73%, which is relatively high by international standards. Lower asset prices will encourage households to repair their balance sheets by repaying debt. In addition, financial institutions will likely cut back on household lending in response to lower collateral values.

Fixed capital investment is expected to fall by about 6% in the first half of 2009 and be flat in the second, for a decline of about 3% for the year. Business confidence indicators reveal an unusually high level of pessimism, which bodes ill for equipment investment. Machinery orders, a good indicator of equipment investment, dropped by 32% and 44% in November and December 2008 from a year earlier. A buildup of unsold houses will exacerbate the softness of the housing market (Figure 3.11.8) and act as a drag on construction. Still, massive planned public works will help offset weak private construction investment. The 2009 government budget has earmarked W24.7 trillion for infrastructure investment, a hefty increase of 27% from 2008.

Inflation is projected at 2.0% for 2009, below the Bank of Korea's inflation target band but well above deflation. The widening gap between potential output and actual output in the face of softening external and domestic demand should choke off inflation pressures. The deflationary impact of lower oil prices and the inflationary impact of won depreciation will largely offset each other. Labor market conditions are set to deteriorate further: the unemployment rate is projected to rise to about 4%, reflecting a decline in hiring as well as the rise in job losses as industrial restructuring intensifies. A rise in the number of workers who drop out of the labor force

3.11.7 Current account balance



Sources: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 9 March 2009; staff estimates.

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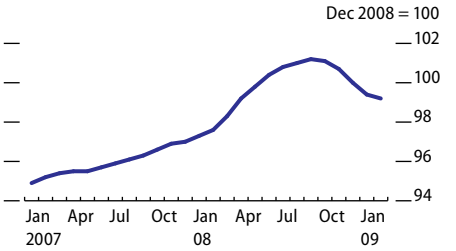
3.11.8 House price index



Source: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 9 March 2009.

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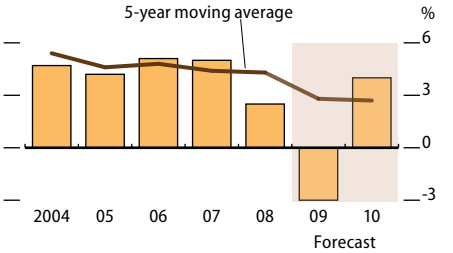
will partly mask the extent of unemployment. There is limited scope for further monetary easing, given that interest rates have already dropped substantially and that additional currency depreciation is a risk.

Taking these factors into account, GDP is projected to fall by 3.0% in 2009 (Figure 3.11.9), which would be Korea's first contraction in output since 1998. Recovery is expected to be moderate and gradual, and take the form of an asymmetric U-shape in which the recovery is more drawn out than the sudden initial output decline. Korea's business cycle is expected to trough in the first half, when output falls by 5.0%, before experiencing a smaller output decline of 1.0% in the second. GDP growth is forecast to resume in 2010 at 4.0%. This will come from the expected recovery of both external and domestic demand and will reflect the effects of a lower base due to the contraction of 2009.

The main source of uncertainty—and of both the upside and downside risks—to these forecasts is the length and depth of the global downturn. The downside risks outweigh those on the upside, that is, a contraction deeper than 3% is more probable than a shallower one. The second major source of uncertainty is the effectiveness of countercyclical fiscal policy in limiting the contraction.

3.11.9 GDP growth



Sources: Bank of Korea, Economics Statistics System, available: http://ecos.bok.or.kr/EIndex_en.jsp, downloaded 9 March 2009; staff estimates.

Click here for figure data

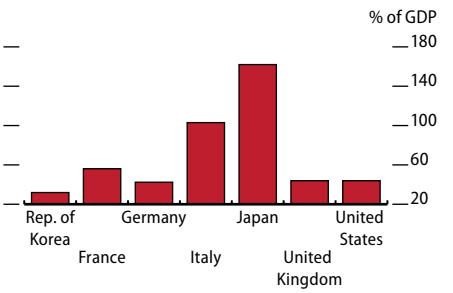
Development challenges

The large size of the Korean economy (between the 11th and 15th biggest in the world, depending on the measure) and its relative high per capita income suggest a sizable domestic demand base relative to most other Asian economies. Despite this advantage, the current global slowdown has severely affected national economic performance, which indicates that the economy remains hostage to the global business cycle.

In light of this, a key challenge for policy makers is to smooth domestic expenditure so as to cushion rather than amplify the impact of external fluctuations. Given the current low level of consumer and business confidence, the impact of monetary policy on aggregate demand will be limited. The burden of macroeconomic stabilization will therefore fall on fiscal policy. Fortunately, years of fiscal prudence have left the Government with plenty of ammunition (Figure 3.11.10). It plans to implement a large fiscal stimulus package of W35.6 trillion, amounting to 4% of GDP. This includes W15.6 trillion of expenditures and W20 trillion of tax cuts. Further fiscal stimulus through supplementary budgets or off-budget measures may be adopted. An increase in public infrastructure investment will also boost aggregate demand.

The Korean experience suggests that the Government's role as a spender of last resort takes on added significance in the face of external fluctuations. This is all the more so since large parts of private domestic demand, such as investment in export-oriented industries, move in tandem with external demand. The need to secure adequate fiscal space to smooth domestic expenditures underlines the need for prudent fiscal policy. Put differently, an important additional benefit of fiscal prudence is that it gives the Government the capacity to limit the damage from externally induced downturns. Finally, volatility due to the global business cycle strengthens the case for automatic fiscal stabilizers, especially expenditure items that move against the cycle. For example, there is some scope for expanding unemployment benefits.

3.11.10 Government debt, 2007



Sources: International Monetary Fund, *International Financial Statistics* online database; Organisation for Economic Co-operation and Development, OECD Statistics Portal, available: http://www.oecd.org/statsportal; both downloaded 9 March 2009; staff estimates.

Click here for figure data

Mongolia

Buffeted by the slump in global prices for copper and other commodities, economic growth started to slow in 2008 and will decelerate sharply in 2009. The current account and fiscal positions have deteriorated, and inflation is at high levels. The Government has pledged to restore fiscal discipline and strengthen the banking system, while protecting the poor from the impact of the economic downturn. The severe impact of the global commodity slump highlights the need for a system to mitigate revenue volatility and to diversify sources of growth.

Economic performance

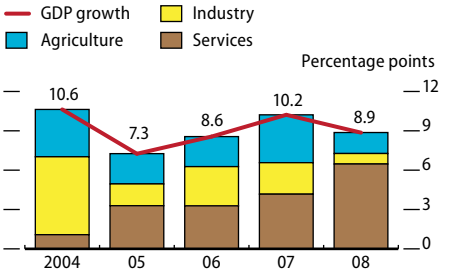
GDP grew by an estimated 8.9% in 2008, down from the previous year's double-digit rate but close to the average of the previous 5 years. Agriculture, which supports about 40% of the population, grew by 5.0%, aided by favorable weather and fiscal incentives to produce wheat. The wheat harvest itself surged by 85.5% and the livestock herd—mainly goats, sheep, and cattle—rose by 7.5% to 43.3 million. In contrast, prices of cashmere, a leading export, fell by about 45% during the year. Services output climbed by 15.9% and this was the source of most of the GDP growth last year (Figure 3.12.1). Growth in banking services was spurred by double-digit expansion in real estate services, wholesale and retail trade, and communications.

Industrial growth came in below 1% for its lowest rate in a decade. Production of copper, the country's biggest export, was hurt by a fall in the metal's price of more than 60% on the London Metal Exchange between July 2008 and year-end (Figure 3.12.2). Among other important mineral exports, global prices of coal and zinc also dropped, although gold was firm. Extended delays in concluding agreements, between the Government and the holders of the mining licenses at the large Oyu Tolgoi copper and gold deposit and the Tavan Tolgoi coal seams, hampered development of mining.

Rapid expansion in public investment, fueled by a surge in government revenue from high commodity prices during the commodity boom, contributed to an upsurge in construction. During the boom, the Government also broadened social assistance and transfer payments to about half the population, and doubled public sector wages over a period of 2 years. These moves, coupled with growth in remittances (close to a fifth of the labor force worked abroad in 2008) bolstered consumption, particularly in the first half of last year. However, many of the factors that drove high growth in the first 3 quarters of 2008 triggered a sharp contraction in the fourth, when commodity prices slumped, remittances slowed, and spending on public investment and real estate projects declined.

The hikes in government expenditure raised total public spending to the equivalent of 40.2% of GDP in 2008, from 27.5% in 2005. When mineral

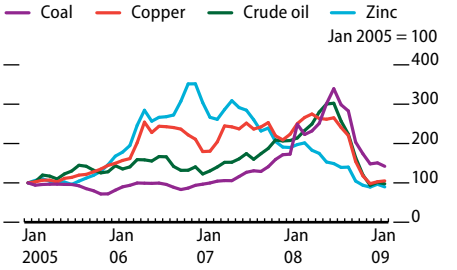
3.12.1 Contributions to growth (supply)



Source: Mongolian National Statistical Office.

Click here for figure data

3.12.2 Global prices of main exports



Source: International Monetary Fund, *International Financial Statistics* online database, available: http://www.imfstatistics.org/imf, downloaded 10 March 2009.

Click here for figure data

This chapter was written by Luvsanchultem Vanjildorj of the Mongolia Resident Mission, ADB, Ulaanbaatar.

prices sank last year, revenue declined to an estimated 35.2% of GDP, and the budget slid into deficit (of about 5.0% of GDP), after 3 years of surpluses.

Mongolia imports much of its food and all its petroleum. Soaring global prices for these items in the first half of 2008, together with expansionary fiscal and monetary policies, propelled inflation to a year-on-year peak of 34.2% in August (Figure 3.12.3). In response, the Bank of Mongolia tightened monetary policy by raising the reserve ratio for commercial banks by 50 basis points to 5.5% and its policy interest rate by 185 basis points to 10.25%. Money supply (M2) growth slowed in the second half; during the same period, growth of commercial bank credit decelerated from 60% to about 28% year on year. Inflation eased to 22.1% by December, giving a year-average of 26.8%.

Buoyant domestic demand for much of the year and the higher prices of imported petroleum and food products in the first half pushed up merchandise imports by about 60% in 2008. Exports grew at about half that pace. The value of most commodity exports declined as world prices slumped, and the value of clothing shipments fell by 69% during the year. The trade deficit widened to an estimated $600 million. Inbound tourism, as well as remittance inflows, slowed in the second half. These developments contributed to a deficit on the current account of about 12.9% of GDP, the first deficit in 5 years (Figure 3.12.4).

The weakening current account put downward pressure on the togrog, prompting the Bank of Mongolia to sell foreign currency. That action contributed to a fall in international reserves from more than $1 billion in July to $657 million at the end of the year (and only 10 weeks of import cover). Late in 2008, the central bank eased its market intervention, and the togrog weakened sharply. Speculative pressure on the exchange rate intensified early in 2009, taking the togrog to MNT1,600/$1 in the first week of March, from MNT1,050/$1 in December 2008 (Figure 3.12.5).

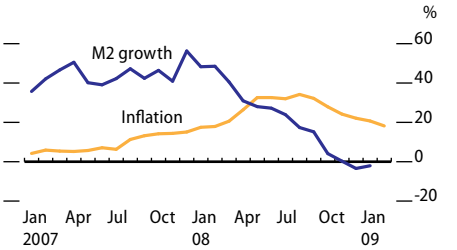
Banking also showed signs of stress. High inflation widened negative deposit interest rates which, combined with currency depreciation, led to withdrawals from togrog deposits and a liquidity squeeze among the banks. In December 2008, the Government took over the fourth-biggest bank (in terms of outstanding loans) when the bank foundered because of mismanagement and a run on deposits. In another move to stabilize the banking system, the authorities issued a blanket deposit guarantee. The banks, concerned about the health of other financial institutions as well as borrowers, clamped down on their lending. Nonperforming loans more than doubled from 3.4% of total loans in 2007 to 7.2% in 2008 (including the assets of the government-rescued bank).

External debt has declined over several years, to an estimated 33% of GDP in 2008. The debt is largely on concessional terms. Fitch Ratings in January 2009 downgraded Mongolia's sovereign debt rating from B+ to B, with a negative outlook, citing weakness in the country's reserves, exchange rate, and banking system.

Economic prospects

Economic growth will decelerate sharply in 2009, dragged down by the slump in prices for export commodities and by related fiscal weakness that will require cuts in government spending. The drop in prices for

3.12.3 Inflation and money supply



Source: Bank of Mongolia, available: www.mongolbank.mn., downloaded 13 March 2009.

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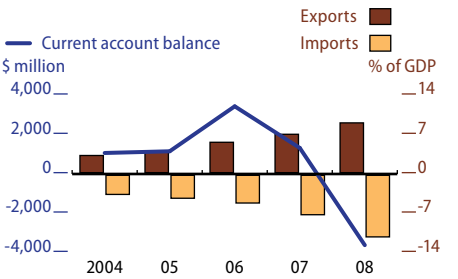
3.12.4 External sector



Source: Bank of Mongolia.

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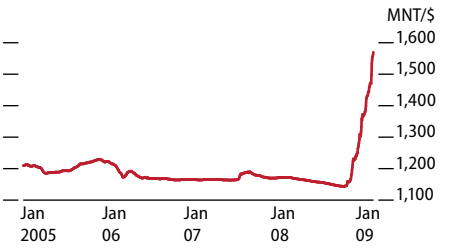
3.12.5 Exchange rate



Source: Bank of Mongolia, available: www.mongolbank.mn., downloaded 13 March 2009.

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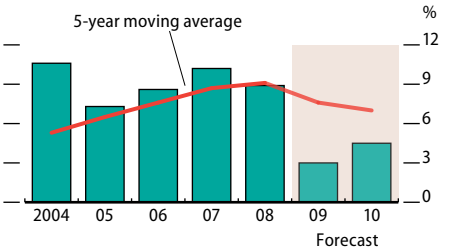
3.12.6 GDP growth



Sources: Mongolian National Statistical Office; staff estimates.

Click here for figure data

minerals and cashmere will suppress the output of these commodities and the incomes of their producers. The outturn for agriculture depends heavily on the weather, which has been favorable for several years. Construction activity will be hurt by the combined effects of the fall in property prices (which started in the second half of 2008), a likely decline in public investment, continued delays in mining-project agreements, and banks' caution. The outlook for services such as finance, domestic trade, and tourism is clouded by the banking system strains and the subdued global outlook for tourism.

Government revenue is expected to fall sharply in 2009, by as much as 11 percentage points of GDP. Unless the Government substantially curtails spending to match the decline in revenue, the fiscal deficit could reach an unsustainable level of above 10% of GDP.

Taking these factors into account, GDP growth is forecast to pull back to about 3.0% in 2009 (Figure 3.12.6). Growth is expected to pick up to about 4.5% in 2010, contingent on four factors: the global economic environment starts to recover as assumed; the Government concludes agreements for the two big mining projects and investment in them starts in 2010; the economy steadies in 2009, enabling a return to investment and employment growth next year; and the domestic financial system stabilizes, facilitating growth in banking and in domestic trade.

The decline in commodity prices, coupled with slower economic growth in the People's Republic of China, which takes nearly two thirds of Mongolia's exports, points to a fall in merchandise exports in 2009. Similarly, inflows from tourism and remittances are likely to contract. Imports, too, will decline, curtailed by the economic slowdown and lower average prices for imported food and fuel. Reflecting these influences, the current account will be in deficit by about 7.0% of GDP. Prospects for foreign direct investment in mining are clouded by substantially weaker global demand for minerals and much tighter international financial markets.

Inflation is expected to decelerate to 9.5% in 2009, and ease further in 2010, a net result of weaker domestic demand and the fall in prices of imported fuel and food on the one hand, offset partly by the impact of the currency's depreciation on the other.

In the context of weakening external and fiscal accounts, the Government agreed with the International Monetary Fund in early March 2009 on an economic program, to be supported by a $224 million loan under an 18-month standby arrangement. Under this, the Government pledged to restore the deficit to a sustainable range, in part through spending cuts, and to strengthen the institutional framework for fiscal policy to prevent a repeat of boom-bust spending cycles. It agreed to strengthen the banking system and follow monetary policies that safeguard its dwindling international reserves. It also committed to better targeting the social transfer programs and to raising the level of support for the very poor.

Economic recovery in the medium term will depend on implementing the economic program and on improving the legal and regulatory environment for mining.

Poverty incidence has declined steadily since 2003, but more than one third of the population lives below the poverty line. High inflation, falling remittances, and plunging prices for cashmere (an income source for herders), risk driving more of the near-poor households into poverty.

3.12.1 Selected economic indicators (%)

	2009	2010
GDP growth	3.0	4.5
Inflation	9.5	8.0
Current account balance (share of GDP)	-7.0	-6.0

Source: Staff estimates.

3.12.1 Development challenges

Addressing the immediate fiscal and banking strains requires bold measures to contain budget outlays, to restore confidence in the banking system and the currency, and to stimulate foreign direct investment. Yet crucially, vital antipoverty programs need to be protected and if possible strengthened given the potential rise in the number of poor people.

The country relies heavily on commodity prices that mirror global market swings, underscoring the need to mitigate the economic and social impact of this volatility by setting up new systems. These in turn require legal, administrative, and financial structures to manage windfall revenue during commodity booms so that sufficient financial reserves are in place during the ensuing bust. The Government set up the Mongolia Development Fund with this in mind, but drew down on its reserves even during the commodity boom. Improved standards of governance are a prerequisite for establishing a strong institutional framework for such a stabilization fund.

Diversification of the narrow base of the economy will involve substantial investment in the social and physical infrastructure and better conditions for development of the private sector. The latter is hampered by a cumbersome regulatory system, weak implementation of laws, shortages of skills, and lack of access to funding at reasonable costs for small and medium-sized enterprises.

The country is urbanizing rapidly, putting severe strains on the environment and on the state's ability to deliver services, which will only be eased by significant investments in urban infrastructure and services. Damage from mining-related toxic spills and desertification from overgrazing also need to be remedied.

Taipei,China

Late last year external demand slumped for this economy's manufactured products, including its vital electronics exports. With domestic demand also contracting, GDP growth was minimal. Inflation accelerated to a 14-year high, then subsided by year-end. Even though substantial fiscal stimulus is being injected this year and interest rates have been lowered, the economy is forecast to shrink by 4.0% before resuming low-level growth next year.

Economic performance

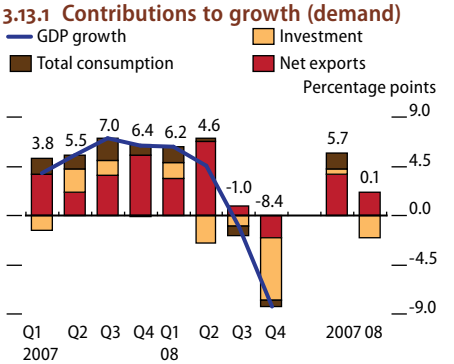
Heavily dependent on external trade, Taipei,China suffered more than most economies in the second half of 2008 as the global slowdown cut into world trade. After growing by an average of 5.4% in the first 2 quarters of the year, GDP contracted by 1.0% in the third and by a vertiginous 8.4% in the fourth. Growth for the full year was just 0.1% (Figure 3.13.1), the weakest outcome since a 2.2% contraction in 2001 when the global information technology bubble deflated.

The slowdown over the year stemmed from a slump in exports of machinery and electronics products and the depressing impact that had on fixed investment. Private investment contracted by 13.5% over the year (Figure 3.13.2) as the outlook deteriorated for manufacturing industries. Public investment declined as well, by about 1%. Investment overall subtracted 2.0 percentage points from total GDP growth in 2008. Against the background of weak consumer confidence and a sliding stock market, consumption was flat. The weakness in domestic demand was offset by some growth in net exports, and it was only that which enabled the marginal full-year expansion of GDP.

Industrial production started to slow in September and plunged by 32.0% in December (year on year). Manufacturers cut production of electronic parts and components, which account for nearly 10% of GDP, as global demand for these items shriveled. Industry as a whole contracted by 1.2% in 2008, a sharp turnaround from the 9.3% expansion in 2007. Moreover, agricultural production fell by 1.4% owing to cold weather in the first half of the year. Growth in services at 0.8% was the lowest since 2001, with particular weakness in wholesale trade and financial services. Still, it was only services that contributed any GDP growth on the supply side.

The economy has become increasingly reliant on external demand, with exports and imports of goods and services each equivalent to about 70% of GDP in 2008. This reflects the expansion of manufacturing production chains with neighboring economies, particularly the People's Republic of China (PRC). The United States (US) is the final destination of much of the production from these chains. Growth in merchandise exports to the PRC in 2008 slowed to 7.2% from 20.5% in 2007. Exports

3.13.1 Contributions to growth (demand)



Sources: Directorate General of Budget, Accounting and Statistics, available: http://eng.dgbas.gov.tw, downloaded 4 March 2009; staff estimates.

Click here for figure data

This chapter was written by Akiko Terada-Hagiwara of the Economics and Research Department, ADB, Manila.

to the US fell in absolute terms by 4%, a second consecutive year of contraction in sales to this market.

Trade deteriorated rapidly in the fourth quarter: merchandise exports in nominal US dollar terms fell by 24.9% (Figure 3.13.3), reducing full-year growth to 3.4%. Likewise, merchandise imports fell by 22.3%, trimming full-year growth to 9.6%. The trade surplus in 2008 was about 40% below the prior-year level, and the current account surplus declined to 6.4% of GDP, from 8.6% in 2007.

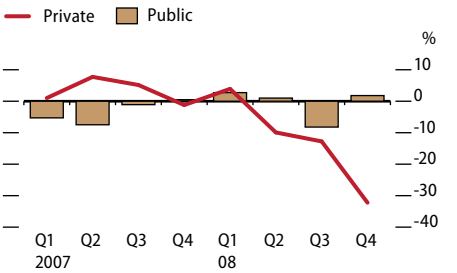
An outflow of portfolio investment in the first 3 quarters of 2008 was reversed in the fourth when residents, growing more risk averse as the global financial crisis deepened, redeemed investments abroad. As a result, lower net portfolio outflows for the year supported an overall balance-of-payments surplus of US$26.3 billion. Gross international reserves grew by 7.9% to US$291.7 billion, and the local currency in nominal average terms appreciated by 4.3% against the US dollar (it depreciated in real terms).

Inflation sped up in the first half of 2008, driven by rising world prices for energy and food. It peaked at 5.8% year on year in July, the highest rate in 14 years. Global energy and food prices pulled back from their highs later in the year, and the domestic economy slowed, bringing inflation down to 1.3% in December.

The monetary authorities, having edged up the policy interest rate continually since mid-2004, switched to an expansionary stance in September 2008 as economic activity slowed. From September to February 2009, they lowered the policy rate by a total of 238 basis points, to 1.25%. Broad money supply (M2) grew by a sluggish 3.0% on average in 2008, although it picked up a little in the fourth quarter. In October, when the global financial crisis worsened, the authorities guaranteed bank deposits in full through end-2009.

Layoffs during the second half of 2008 lifted the unemployment rate to a 5-year high of 5.0% in December, when the number of unemployed hit a record 549,000. Concerns about these job losses, and more broadly about the sharp deceleration of the economy, reversed the authorities' fiscal consolidation efforts of recent years that had reined in the fiscal deficit to 0.4% of GDP by 2007. Increases in public expenditure, at a time of marginal growth in revenue brought about by weakness in tax income, widened the fiscal deficit 2.3% of GDP in 2008.

3.13.2 Investment growth



Source: CEIC Data Company Ltd., downloaded 15 March 2009.

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Economic prospects

The slump in global demand for machinery and electronics products (about half all merchandise exports), and the knock-on effects to consumption and investment, will cause the economy to contract in 2009. Most of the world's laptop computers and liquid crystal display panels are manufactured in Taipei,China—the type of durable goods that face particularly weak demand worldwide. Early trade and production figures for 2009 were bleak: merchandise exports plunged by an average 36.3% year on year in the first 2 months. (Shipments to the PRC dropped by 48% in this period.) Industrial production fell by 43.1% in January.

The authorities, from September 2008 to February 2009, announced several fiscal stimulus measures to support consumer and business

3.13.1 Selected economic indicators (%)

	2009	2010
GDP growth	-4.0	2.4
Inflation	0.6	1.2
Current account balance (share of GDP)	8.4	8.3

Source: Staff estimates.

spending and generate jobs. These measures included tax breaks for new investment by businesses, discounted sales of industrial land, and increased financial support for small and medium-sized firms. Investment in public infrastructure of about US$15 billion is planned over the next several years, with about 30% of it (1% of GDP) allocated for this year.

Nevertheless, private fixed investment is expected to decline further in 2009. Fixed investment is strongly correlated with the performance of merchandise exports (Figure 3.13.4), so it is unlikely to pick up significantly until manufactured exports rise, which will be some time, given that export orders have dived. Moreover, inventories of manufactured products have mounted steadily in recent months. Permits for construction, too, have trended lower. Consequently, private fixed investment is projected to fall by 6.3% in 2009, before picking up in 2010.

Measures to spur sluggish consumption have involved cash transfers equivalent to about US$200 to low-income families and subsidies for consumers to buy energy-saving products, such as solar water heating systems and low-emission vehicles. Shopping vouchers valued at NT$3,600 (about US$100) were handed out to all citizens, including children, starting in January 2009. These transfers seemed to have an impact: sales at department stores and supermarkets rose by about 20% year on year in January. Some department stores reported their highest-ever one-day sales in the days after the vouchers were passed out.

But from a multi-month perspective, consumer confidence has continued to decline since mid-2008 (Figure 3.13.5). Consumption is forecast to contract by about 2% in 2009, against the backdrop of the weak labor market and reduced household wealth. Taking these influences into account, GDP is projected to shrink by 4.0% this year (Figure 3.13.6). Growth is forecast to resume at a low level (2.4%) in 2010, on the expectation that the global economic environment improves next year and that stimulus measures in both Taipei,China and the PRC have an appreciable impact. An expected gradual recovery in manufacturing in 2010 will bolster the labor market, which, coupled with low inflation, is expected to support a moderate pickup in consumption.

With global trade seen contracting in 2009, merchandise exports are forecast to fall by 3.5%. Imports will fall even faster than this, by about 6.3%, on lower prices for imported commodities compared with 2008, weaker domestic demand, and fewer imports of raw materials for export industries. The current account surplus is forecast to increase to about 8.4% of GDP in the forecast period.

The expansionary fiscal policy is projected to widen the fiscal deficit to 5.0% of GDP in 2009. Domestic bond issuance will be the main funding source for the stimulus measures. Fitch Ratings in January 2009 cited deteriorating public finances when it lowered its outlook on the AA long-term local-currency rating to negative from stable. Next year, the fiscal position is expected to improve, if external demand picks up and the stimulus measures lift domestic demand, in the process strengthening tax receipts.

Inflation is expected to average 0.6% this year before edging up to 1.2% in 2010. The consumer price index rose by 1.5% in January, but fell by 1.3% in February. Given concerns about possible deflation, monetary policy is expected to remain expansionary.

3.13.3 Merchandise trade growth

Source: CEIC Data Company Ltd., downloaded 15 March 2009.

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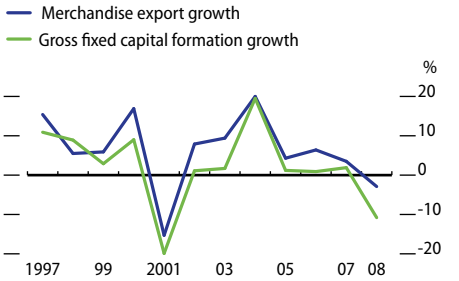
3.13.4 Investment and exports



Source: Directorate General of Budget, Accounting and Statistics, available: http://eng.dgbas.gov.tw, downloaded 2 March 2009.

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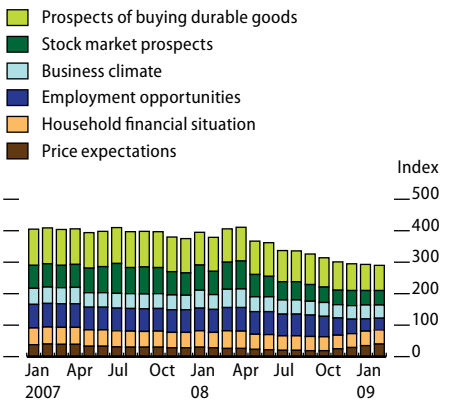
3.13.5 Consumer confidence for the next 6 months



Source: CEIC Data Company Ltd., downloaded 15 March 2009.

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To help spur growth in the longer term, the authorities are establishing closer economic ties with the PRC. Four agreements aimed at expanding trade across the strait were signed in November 2008. They cover air and shipping routes, postal exchange, and greater cooperation on food safety relating to imports from the PRC. The near-term impact on growth is likely to be slight though, given the economic slowdown in both economies

The main domestic risk to the forecasts is that the fiscal stimulus fails to have a significant impact, in which case the economy would contract more than forecast and the slowdown could be extended. Fiscal strains would also intensify, as the recovery in tax revenue would be delayed.

Development challenges

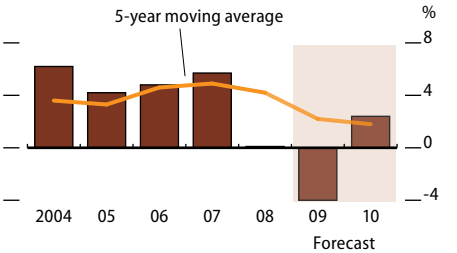
An aging population and inadequate state pensions are inducing high household saving in Taipei,China. Households are the source of more than half of all national saving, compared with about 20% in the Republic of Korea.

The high household saving rate largely stems from workers' concerns about the adequacy of the state retirement pension, which is funded by contributions from employers and employees. However, enforcement of employers' contributions is weak. Furthermore, given that a growing proportion of the population will draw on this pension system for basic needs as the average age rises, many are concerned that the system might not have sufficient funding to meet even the current low pension payments. The old-age dependency ratio, the share of people aged 65 and older as a proportion of the working population, is projected to more than double between 2001 and 2036, to above 30%.

Some steps have, though, been taken to strengthen the pension system. A reform that came into effect in October 2008 allows workers to switch jobs without losing their accumulated contributions—that is, the pensions have become portable. This has improved labor market flexibility and increased the number of people eligible for a pension in retirement. However, until the pension system is enhanced, workers are likely to maintain high precautionary saving rates.

Until about 10 years ago, the need to save for medical treatment was another reason for the high saving rate. A national health insurance system that was launched in 1995 has had a significant impact in reducing individuals' precautionary saving for medical expenses, particularly those on low incomes.

3.13.6 GDP growth



Sources: Directorate General of Budget, Accounting and Statistics, available: http://eng.dgbas.gov.tw, downloaded 4 March 2009; staff estimates.

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South Asia

Islamic Republic of Afghanistan
Bangladesh
Bhutan
India
Maldives
Nepal
Pakistan
Sri Lanka

Islamic Republic of Afghanistan

Worsening security and the global downturn have made the socioeconomic situation even more difficult. Severe drought caused a sharp fall in agricultural output and a slump in GDP growth in the licit (non-opium) economy. Lower farm output and the escalation of global food and fuel prices pushed inflation to its highest level in 5 years, but it began to moderate toward the end of the year. The challenges are daunting, and, to name but a few, involve the need to strengthen security, rehabilitate basic infrastructure, combat narcotics production, improve the rule of law, strengthen public policy management, and foster private sector growth.

Economic performance

In FY2008 (ending 20 March 2009), drought hit agricultural production, which represents about a third of licit GDP. Although continued expansion in construction and services partly offset this decline, GDP growth is estimated to have slumped to 3.4% (Figure 3.14.1).

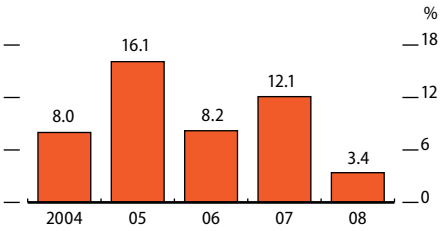
The country experienced a serious food crisis in FY2008 owing to a 40% lower wheat harvest than in FY2007 (partly because of poor rainfall that affected nonirrigated crops particularly); surging global prices of wheat and other foods (combined with a high dependence on food imports); and restrictions on wheat exports from Pakistan (the main source of supply).

As food accounts for three fifths of the consumer basket and as wheat is the staple, the consumer price index for Kabul, which began rising in late 2007, jumped by 43.2% year on year in May 2008 before falling to 22.7% in December. That month saw a 30.3% increase in food prices but an easing in nonfood prices in the basket of 10.7% (Figure 3.14.2). For FY2008, inflation averaged an estimated 28.3%, compared with 12.9% the prior year.

A combination of deteriorating security, the continued lack of basic infrastructure (mainly power), and what is seen to be rampant corruption has hampered government efforts to boost private sector investment. Nongovernment investment was essentially unchanged in FY2008 from a year earlier at 7.7% of GDP, and below the 9.6% and 8.1% shares recorded in FY2005 and FY2006. Overall investment as a share of GDP declined to about 32.0% from an estimated 36.7% in FY2007.

The opium economy, equivalent to about 20–30% of licit GDP, remains a grave challenge. Counter-narcotic efforts helped cut estimated opium production by about 6% in calendar 2008 from record production a year earlier, even as border prices fell to $70 a kilogram (Figure 3.14.3). Afghanistan still produces around 90% of the world's opium, and the opium trade remains a major source of income for nearly 80% of the rural population. Potential earnings from poppy farming are much higher than from alternative crops, and financing for the crop from drug traffickers is readily available.

3.14.1 GDP growth



Source: International Monetary Fund, Country Report, February 2009 (unpublished).

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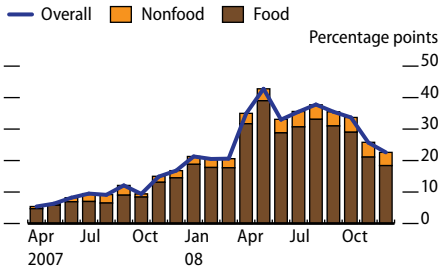
3.14.2 Contributions to inflation



Note: Data refer to Kabul only.

Source: Central Statistics Office.

Click here for figure data

This chapter was written by Mohammad Ishaque Sarwari of the Afghanistan Resident Mission, ADB, Kabul.

As a result of poor revenue performance and unanticipated expenditure (mainly related to increased security costs), the Government's Medium-term Fiscal Framework target of being able to fully finance its operating budget through domestic revenue will be delayed by 3 years, to FY2016. Due to a lower than expected volume of taxable imports and inadequate tax collection, domestic revenue is estimated to have declined to 6.6% of GDP in FY2008 (Figure 3.14.4), and is likely to have covered only about 55% of operating spending, or 11 percentage points lower than in FY2007.

Development budget execution, which had improved to about 55% of the budgeted target in FY2007, is estimated to have reached only about 42% in FY2008 because of the Government's limited absorption capacity. Lack of staff with skills in project implementation and management continued to have a negative impact on contracting and procurement, resulting in delays affecting physical progress as well as planned budget disbursement.

The external budget—the portion of the budget that donors implement directly—continued to account for more than half total public spending. That so much of total spending is outside the government budgeting process complicates the Government's development agenda in terms both of setting priorities and of monitoring progress against desired outcomes according to the Afghanistan National Development Strategy (ANDS), which was endorsed at the Paris International Conference in June. The Government would like to see more external funding channeled through the core budget.

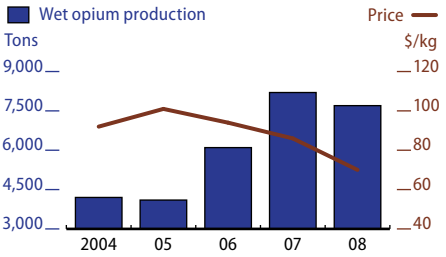
The Government has made progress in public financial management, including budgeting and accounting reforms. Some central ministries are now undertaking program budgeting, which is increasingly seen as a useful tool to align ministry strategies with the ANDS.

Monetary policy aims to support price and exchange rate stability. Inflation is expected to continue moderating from the high levels seen in early 2008 as a result both of declining global food and oil prices and of the Government's prudent monetary and fiscal policies. The nominal exchange rate remained stable at around AF50/$1 (Figure 3.14.5).

The Government's monetary policy has been adjusted to accommodate balance-of-payments pressures resulting from emergency imports of large quantities of wheat. The net international reserves target has therefore been adjusted downward to about $2.9 billion from the earlier $3.0 billion monetary program target. Targets for reserve money and currency in circulation were correspondingly adjusted to ensure that monetary policy contributes to disinflation, capitalizing on the declining prices of imported food and fuel.

The current account deficit in FY2008, excluding grants, is estimated to have widened to $7.1 billion, or about 58% of GDP, from $6.4 billion a year earlier. The increase reflected a widening of the trade deficit stemming from greater imports associated with donor-financed activities, including security and development projects. Domestic official exports (that is, exports excluding transit trade and smuggling) are estimated to have risen by about 27% to $610 million, or 5% of GDP. Including grants, the current account deficit is put at about 1.3% of GDP, financed by inflows of foreign direct investment ($300 million) and concessional loans.

3.14.3 Opium production and prices



Source: International Monetary Fund, Country Report, February 2009 (unpublished).

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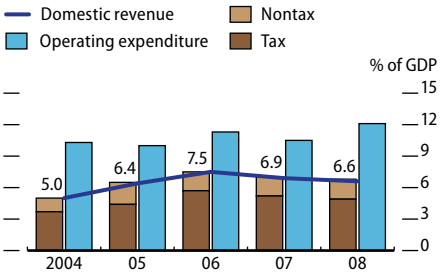
3.14.4 Domestic revenue and operating expenditure



Source: International Monetary Fund, Country Report, February 2009 (unpublished).

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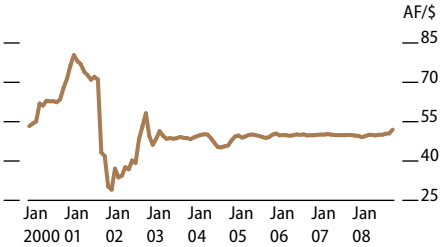
3.14.5 Nominal exchange rate



Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 9 March 2009.

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The International Monetary Fund's fourth review of the 3-year Poverty Reduction and Growth Facility (PRGF) ended in July 2008. The PRGF will enable Afghanistan to be eligible for debt relief under the Heavily Indebted Poor Countries (HIPC) initiative. The Government has continued to work toward reaching its HIPC "completion point" by the end of this year, and for this purpose it is pursuing agreements to settle its bilateral debts with the Czech Republic and the Kuwait Fund so as to regularize its relations with those external creditors not included in the Paris Club. Afghanistan's loans from the OPEC Fund were restructured in September 2008, and the Government intends to recognize its debts to the Islamic Republic of Iran and to request a waiver in light of its expected HIPC status.

For the ANDS, the Government has established a coordinating committee, consisting of key ministers and senior officials, to oversee the progress of implementation. Donors have input through the Joint Coordination Monitoring Board.

Parliament approved a new Civil Servants Law in July 2008, which includes provision for a new pay and grading structure for the whole civil service. The Government originally planned to start bringing into effect the new structure for 10% of civil servants during the second half of the current fiscal year. However, since a prerequisite under the new law is the regrading of positions, any significant fiscal impact is not expected before FY2009.

Although private sector–led economic growth is a major objective of the ANDS, progress in encouraging private development has been slow. To foster such development, an Afghanistan Investment Climate Facility was established in June last year. In addition, an enabling committee for the private sector and civil society has been established as a public–private forum to play a leadership and advocacy role.

3.14.1 Selected economic indicators (%)

	2009	2010
GDP growth	9.0	7.5
Inflation	6.0	6.8
Current account balance (share of GDP)	-3.5	-4.7

Source: Staff estimates.

3.14.1 Development challenges

Poor security, weak governance, and a poor environment for the private sector remain critical concerns. Additionally, lack of both physical and economic infrastructure (including stable power supply), land titling, and access to finance are hobbling the private sector.

A greater focus on development management and aid effectiveness, through better prioritization, would enable the Government to tackle these problems. However, until the presidential election scheduled for later this year is held, the Government may have difficulty in getting the National Assembly to approve crucial reform measures.

Economic prospects

Externally financed development has buttressed growth in the licit economy. On the assumption of continued large inflows of donor funding and no drought or other factors that would affect agricultural production, GDP growth is forecast to rebound to 9.0% in FY2009 and then decline to 7.5%. Average inflation is expected to fall to 6.0% and then edge up to 6.8% in this period, reflecting the decline in global prices of food, fuel, and other commodities.

The external position is seen improving on the back of sustained large inflows of official transfers. Official development assistance and foreign direct investment, as well as debt relief through the HIPC initiative, will finance the small deficits in the current account (once official transfers are included).

Medium-term prospects depend heavily on the Government's success in combating corruption, overcoming infrastructure bottlenecks, and implementing further structural reforms, all of which are needed to stimulate private sector investment. Moderate to high growth targets will be attainable only if structural reforms are put through decisively and if public investment is targeted to key areas of infrastructure, notably transport and electricity.

Bangladesh

Growth prospects are dimmed by the global economic slowdown, but inflation has eased with falling global commodity prices. The new Government should raise infrastructure investment and improve the enabling environment for private sector activity, in order to enhance prospects for rapid growth and job creation. This in turn will require improved implementation of the development expenditure program as well as strengthened revenue mobilization. Addressing power and gas shortages will be particularly important for enhancing longer-term growth prospects, especially in terms of encouraging private investment.

Economic performance

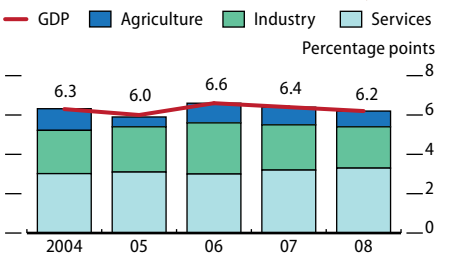
GDP growth at 6.2% was slightly lower in FY2008 (ended June 2008) than in the previous year, because of weaker growth in industry and agriculture (Figure 3.15.1). Industrial growth was pulled back by a dip in garment production in the first half of the fiscal year, as well as by higher raw material import costs and growing energy shortages. Natural disasters in the first half affected agricultural output. Growth in services was supported by expansion of transport and storage and of wholesale and retail trade.

On the demand side, growth continued to be driven by private consumption (Figure 3.15.2) aided by an ongoing surge in remittances. Total fixed investment fell to 24.2% of GDP, reflecting a cut in the Government's annual development program (ADP), and slower growth in private investment, caused partly by the uncertainty created by the Government's anticorruption drive. While private investment rose marginally to 19.2% of GDP in FY2008 from 19.0% in FY2007, public investment fell from 5.5% of GDP to 5.0%. The fall in investment over the past 2 years is manifesting itself as surpluses in the current account, signaling the need to rebalance growth by boosting investment, while keeping the current account balance at manageable levels. The deficit in net exports of goods and services widened, slowing growth more than in FY2007.

Average inflation accelerated from 7.2% to 9.9% in FY2008, on higher global food prices and shortfalls in domestic production. Higher public spending, rapid credit growth, and stronger demand boosted by remittances also contributed to inflation pressures. Inflation moderated in more recent months, declining to 6.1% year on year in January 2009 from 10.2% in September (Figure 3.15.3), as food price rises steadily eased.

Bangladesh Bank stepped up monetary expansion and private sector credit growth as the fiscal year progressed to sustain the growth momentum. The year-on-year expansion in money supply (M2) rose from 14.7% in December 2007 to 17.6% in June 2008, exceeding the central bank's annual program target of 16% (Figure 3.15.4). Private sector credit growth accelerated from 16.8% to 24.9% in the same period, also

3.15.1 Contributions to growth (supply)



Source: Bangladesh Bureau of Statistics, available: http://www.bbs.gov.bd, downloaded 19 February 2009.

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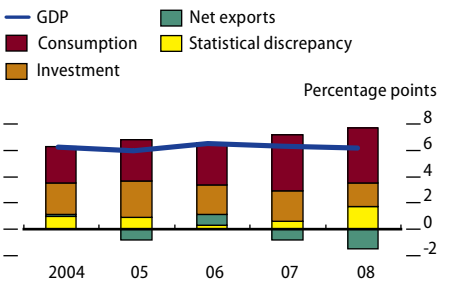
3.15.2 Contributions to growth (demand)



Source: Bangladesh Bureau of Statistics, available: http://www.bbs.gov.bd, downloaded 19 February 2009.

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This chapter was written by Mohammad Zahid Hossain and Md. Golam Mortaza of the Bangladesh Resident Mission, ADB, Dhaka.

overshooting the program target. Although stoking inflation pressures, the accommodative monetary stance helped improve goods availability by boosting imports and raising domestic supply.

In conducting monetary policy, the central bank kept reserve requirements, liquidity ratios, and the main policy rate (reverse repo) unchanged in FY2008, relying more on open-market operations to constrain liquidity. The weighted average yield on 28-day Treasury bills was 7.5% in June 2008, marginally higher than the 7.3% in June 2007. The reverse repo and repo rates (1–2 day maturity) were unchanged at 6.5% and 8.5%, respectively, from December 2007 through June 2008. The weighted average lending rate declined from 12.8% in June 2007 to 12.3% in June 2008, and the weighted average deposit rate of 7.0% remained negative in real terms during this period. The spread between lending and deposit rates remained high at 5.3 percentage points, reflecting banking sector inefficiencies, particularly high administrative costs and still-sizable nonperforming loans. The sector allocation of bank advances to the private sector were broadly unchanged.

The nominal exchange rate remained stable in FY2008, with the taka appreciating only by about 0.5% against the United States (US) dollar, aided by periodic interventions in the foreign exchange market by Bangladesh Bank. The real effective exchange rate depreciated by 0.6% over the year, but appreciated by 3.6% in the first half of FY2009, implying erosion of competitiveness in the international market.

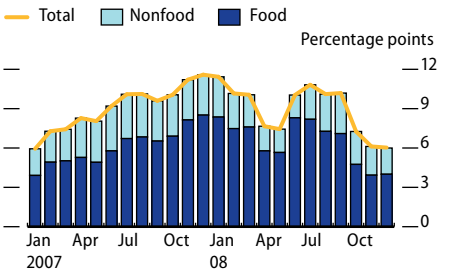
Revenue collection jumped to 11.2% of GDP in FY2008 from 10.2% in the previous year (Figure 3.15.5). Despite the cut in the ADP, public spending rose to 15.9% of GDP, from 13.4% in FY2007, because of higher spending on relief and reconstruction, expanded safety net programs to combat the rise in food prices, and higher subsidies for fuel and fertilizer. Consequently, the fiscal deficit widened to 4.7% of GDP from 3.2% in FY2007.

Measures such as expanding taxpayer registration, modernizing the National Board of Revenue along functional lines, and strengthening its audit functions need to be accelerated so as to further improve revenue performance. Lists of tax exemptions, exclusions, and incentives will also need to be reviewed by the Government and pared down, and income tax and value-added tax laws updated, in order to expand the tax base and raise tax collections.

Exports grew by 15.7% in FY2008, driven by strong performance in knitwear in the second half. The share of woven garments and knitwear, at 75.8% of total exports, was slightly higher than in the previous year. Imports rose by 25.6%, with imports of food, fuel, and fertilizer rising sharply. The higher trade deficit was offset by continued strength in workers' remittances, leading to a small current account surplus of $0.7 billion or 0.9% of GDP (Figure 3.15.6). A smaller surplus in the capital and financial account lowered the overall balance-of-payments surplus to just over $600 million in FY2008 from about $1.5 billion in the previous year. Foreign exchange reserves rose by $1.1 billion, to $6.1 billion at end-June 2008 (import cover of about 3 months), partly reflecting a rise in central bank liabilities (Figure 3.15.7).

Although the financial soundness of private banks strengthened along with their rapid growth in FY2008, the state-owned commercial banks (accounting for about 30% of assets and deposits of the banking system)

3.15.3 Contributions to inflation



Source: Bangladesh Bureau of Statistics, available: http://www.bbs.gov.bd, downloaded 19 February 2009.

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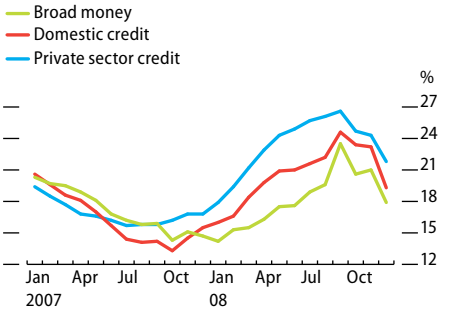
3.15.4 Growth of monetary indicators



Source: Bangladesh Bank, available: http://www.bangladesh-bank.org, downloaded 19 February 2009.

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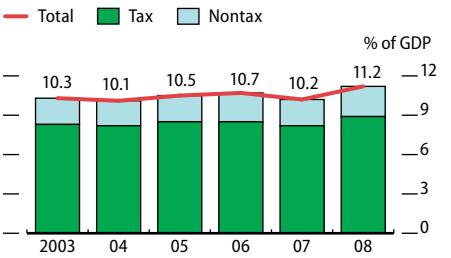
3.15.5 Government revenue



Source: Ministry of Finance, available: http://www.mof.gov.bd, downloaded 19 February 2009.

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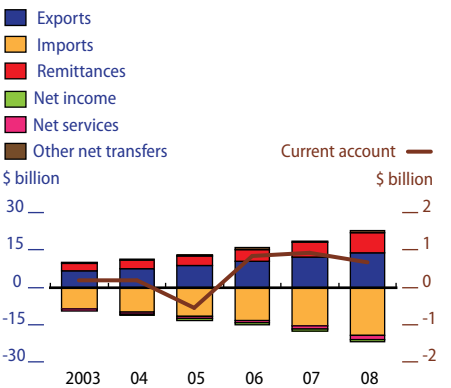
3.15.6 Components of the current account balance



Source: Bangladesh Bank, Annual Report, available: www.bangladesh-bank.org, downloaded 30 December 2008.

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remained weak, with negative capital and a nonperforming loan ratio of 33% (Figure 3.15.8), thus undermining the overall efficiency of the banking system. While operational autonomy and accountability of the state banks rose after their corporatization in 2007, greater attention to credit quality, recovery of nonperforming loans, and intensified monitoring by Bangladesh Bank are needed for improving their financial position. Bangladesh Bank is advising financial institutions to provide more credit to activities that generate domestic value added and create jobs in the country, and to more carefully assess borrowers' creditworthiness, in order to improve the credit quality of these institutions.

The Dhaka Stock Exchange price index dropped by 7.4% in the year to end-2008 (Figure 3.15.9). Since the share of foreign portfolio investment in the stock market is very small and the risk of contagion from international markets is minimal, the downward movement in share prices stems from nervous domestic investors. In the same period, market capitalization rose by 40.5%, reflecting some large initial public offerings. Inefficiencies in the pricing mechanism for such offerings, weaknesses in corporate governance and market surveillance, and the high costs of listing need to be addressed if market capitalization is to rise further in line with other South Asian markets.

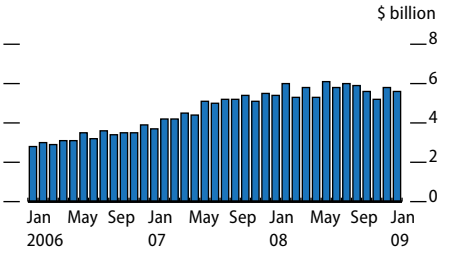
Economic prospects

Prospects for FY2009 and FY2010 will hinge critically on the way in which the democratically elected government (which assumed office in January 2009) continues and deepens the economic reforms initiated during the caretaker Government's 2-year tenure. Prudent macroeconomic management, in particular prompt action to address the downside risks to growth from the global slowdown, will also be required. The Government will need to adopt measures to accelerate ADP implementation, including addressing deficiencies in institutional capacities in key line ministries, raising revenues, and encouraging greater private participation in infrastructure investment. Economic prospects will also depend on the continued availability of adequate external assistance—despite the economic downturn—for supporting public spending on infrastructure, especially for rolling back growing power shortages.

Against this background, GDP growth is forecast to decline to 5.6% in the current fiscal year (FY2009), because of the effects of the global slowdown on exports and remittances and, as anxious consumers trim their spending, of lower domestic demand. GDP growth is forecast to slide further to 5.2% in FY2010 as the global economic slowdown persists, with continued moderation in external and domestic demand (Figure 3.15.10). Agricultural output will rise briskly in the forecast period, if normal weather conditions prevail and if farmers can access credit and inputs.

Industrial growth is expected to moderate in FY2009, as export production begins to slow in the second half of the fiscal year, reflecting cooling global demand. The export sector got off to a robust start in the first quarter, when total shipments surged by 42.4%. In the second quarter, though, they declined by 1.2%, resulting in still-robust, cumulative export growth for the first 7 months of 18.2% (Figure 3.15.11).

3.15.7 Gross foreign exchange reserves



Source: Bangladesh Bank, available: http://www.bangladesh-bank.org, downloaded 19 February 2009.

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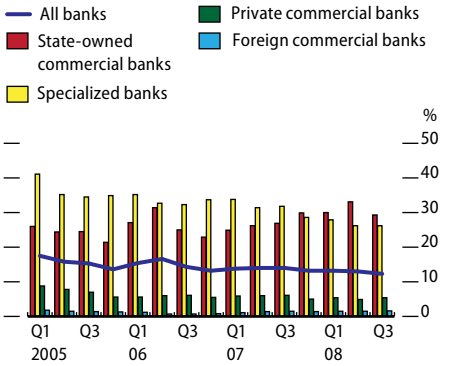
3.15.8 Gross nonperforming loan ratios by type of bank



Source: Bangladesh Bank, available: http://www.bangladesh-bank.org, downloaded 19 February 2009.

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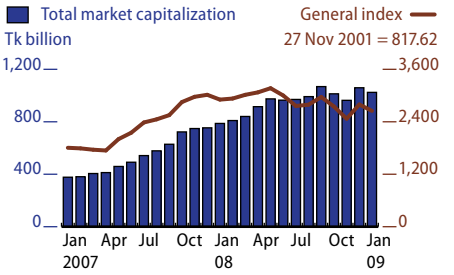
3.15.9 Dhaka Stock Exchange indicators



Source: Bangladesh Bank, available: http://www.bangladesh-bank.org, downloaded 19 February 2009.

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3.15.1 Selected economic indicators (%)

	2009	2010
GDP growth	5.6	5.2
Inflation	7.0	6.5
Current account balance (share of GDP)	0.2	-0.5

Source: Staff estimates.

Deceleration in demand for low-end garment exports from the People's Republic of China (PRC) due to the appreciating yuan and the PRC's graduation from this market segment has provided opportunities for export growth for Bangladesh, where low-end products predominate. International buyers of Bangladesh products have also been encouraged by the large improvements in ports, customs, and safety and labor standards in the past couple of years. Nevertheless, slower growth in export earnings for the rest of FY2009 is foreseen because of the global slowdown and lower prices. Export vulnerability is accentuated by the lack of diversification both in terms of products and destinations—about 75% of exports are concentrated in textiles and over 90% of those exports are destined for US and European markets. Exports that are income elastic, such as frozen foods and leather products, have already shown considerable vulnerability to the global slowdown.

Slower export growth will take down that of industry to 6.6% in the current fiscal year. Next year will see 6.0% industrial expansion as the slump in external and domestic demand continues. Services sector growth will also slow to 6.0%, down from the 6.7% in FY2008, because of slower activity in the export sector and an easing in consumer spending induced by moderation in incomes and remittance growth. Services sector growth will fall to 5.5% in FY2010 due to industry's slowdown. Agricultural growth is expected to edge up to 4.0% in FY2009 and further to 4.1% in FY2010, on the basis of improved crop harvests.

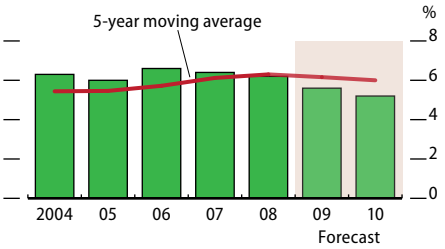
Inflation slowed during the course of the fiscal year. The decline in food inflation was steeper than that of nonfood inflation by end-January. The rapid decline in international commodity prices and good domestic crop harvests are pulling inflation lower. The cut in the domestic administered price of petroleum in October and December, after an increase in July, also eased inflation pressures, as has the modest monetary tightening in the second quarter of FY2009, and the further cut in domestic petroleum prices in January 2009. Inflation is projected at 7.0% for FY2009 and is expected to fall further to 6.5% in FY2010 (Figure 3.15.12).

The Monetary Policy Statement (MPS) announced by Bangladesh Bank in January 2009 envisages no shift in the broadly accommodative policy stance. The central bank continues to support the flow of credit to increase production of goods and services, and provide refinancing against lending in employment-intensive sectors such as agriculture and small and medium-sized enterprises, which are underserved by the market. The year-on-year growth in broad money (17.9%) in December 2008 is in line with Bangladesh Bank's end-June 2009 annual program target of 17.5%.

While the year-on-year growth in private sector credit in December 2008 was 21.8%, the adjustments in the repo and reverse repo rates are expected to guide credit growth back toward the annual program target of 18.5%. The MPS inflation projection of 8.5% for FY2009 appears overly pessimistic, considering the pace at which price pressures are dissipating. However, Bangladesh Bank cut the repo rate in March 2009 (from 8.75% to 8.5%) to encourage banks to lower their lending rates.

The external current account is expected to show a tiny surplus in FY2009 (0.2% of GDP) and a small deficit in FY2010 (0.5%) (Figure 3.15.13). Overseas workers' remittances remain a source of strength for

3.15.10 GDP growth



Sources: Bangladesh Bureau of Statistics, available: http://www.bbs.gov.bd, downloaded 19 February 2009; staff estimates.

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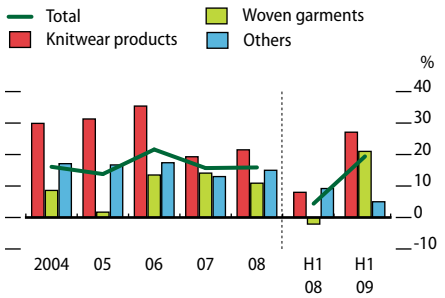
3.15.11 Growth in exports and components



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 19 February 2009.

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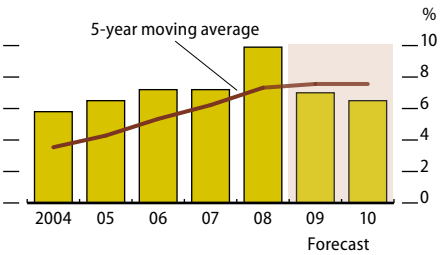
3.15.12 Inflation



Sources: Bangladesh Bank, Economic Trends, available: http://www.bangladesh-bank.org, downloaded 19 February 2009; staff estimates.

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Bangladesh, with 27.0% growth in the year to February. Nearly two thirds of remittances originate in the Middle East, with another one third from the US and Europe. A large majority of overseas workers are unskilled and involved in low-end jobs, which were relatively unaffected, especially in the Middle East, at the beginning of the economic slowdown. But a deceleration in remittance growth is inevitable as the downturn has now deepened, to 20% in FY2009 and to 15% in FY2010.

Similarly, export growth is projected to decelerate, to 14.0% and 13.0% over these two years. Import payments during the first half of FY2009 rose by 23.2% relative to the same period of FY2008. However, the opening of import letters of credit—a leading indicator for annual imports—declined by 2.2% in the first 7 months of FY2009, mainly because of the difficulties for international negotiating banks in supporting import activities in the face of liquidity shortages. With a further fall in international commodity prices, growth in import payments is expected to moderate and settle at 18.0% in FY2009 and 17.0% in FY2010.

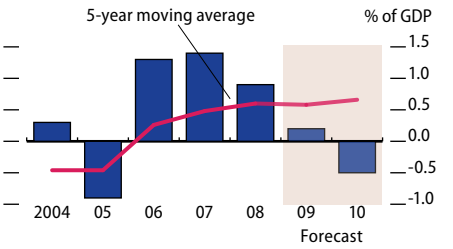
Government revenues are showing signs of deceleration, with growth falling from 20.5% in the first quarter of FY2009 to 12.4% in the first 7 months of the fiscal year, compared with the corresponding periods of FY2008. Slower private sector activity, as the impact of the global economic slowdown takes hold, could further affect revenue collections. Import-based receipts will be hit by the cuts in customs duties made in the FY2009 budget and by the erosion in import values resulting from lower international commodity prices.

Although the Government has transferred some of the benefits of lower international petroleum prices to consumers through successive cuts in domestic prices, the sharp decline in international prices also allowed it to eliminate petroleum subsidies and permitted a small profit for Bangladesh Petroleum Corporation. The lower operating costs for the Power Development Board and Petrobangla will contain their losses and reduce budgetary subsidies. A cut in non-urea fertilizer prices by about 50% in January 2009 will raise the budgetary cost of fertilizer subsidies, but the fiscal strain is likely to be minimal due to the savings on petroleum subsidies, likely ADP underutilization, and lower spending on food subsidies compared with budget targets.

Aided by the Public Resources and Budget Management Ordinance of 2008, which set a cap on domestic government borrowing, current spending is also likely to remain in check. The budget deficit in FY2009 is therefore expected to be 4.7%, within the budgeted level of 4.9% (Figure 3.15.14), despite the weaker revenue performance.

Several risks to the economic outlook could materialize from the global economic slowdown. Revenue collections may come under further pressure if economic activity declines more than expected, which would constrain the Government's ability to spend on essential infrastructure and social sector programs. ADP implementation could be delayed as the new Government takes time to address institutional capacity and personnel management issues. In addition, reversal of economic and sector reforms initiated by the caretaker Government could weaken the business environment and dent business confidence. Finally, a return to confrontational politics could also disrupt economic activity, as could natural disasters.

3.15.13 Current account balance



Sources: Bangladesh Bank, available: http://www.bangladesh-bank.org, downloaded 19 February 2009; staff estimates.

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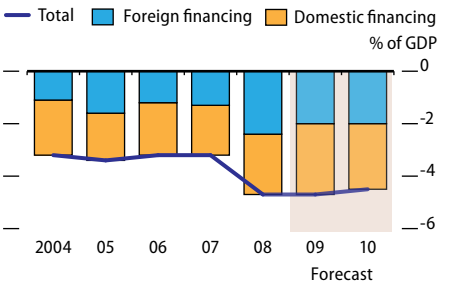
3.15.14 Fiscal balance



Sources: Ministry of Finance, available: http://www.mof.gov.bd, downloaded 19 February 2009; staff estimates.

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Development challenges

Bangladesh needs to substantially raise investment, which has followed a declining trend in recent years, in order to enhance growth and job creation and thereby reduce poverty. Public investment must be raised, primarily by accelerating ADP implementation, but efforts to raise private sector participation in infrastructure investment should also be made. The new Government needs to pay attention to improving institutional capacities in its various agencies, both to implement reforms and strengthen development administration. Over the medium term, with climate change posing a major threat to growth, tackling such concerns needs to be integrated into economic development plans and activities (Box 3.15.1).

The emerging shortages in gas and power supplies (over four fifths of power is generated from gas) need to be urgently addressed. Unless early remedial measures are adopted, power cuts and irregular electricity supplies will hamper domestic production and hold back medium-term growth prospects. In the longer term, the lack of gas supplies will severely limit power generation and, therefore, new investment in manufacturing activities. Large and rapid investments in gas and power are essential to ensure their continued availability. As foreign direct investment flows in gas and power are unlikely to materialize soon because of the global financial market turmoil, the Government must mobilize its own resources and tap external donor assistance. Investments in other infrastructure, such as roads, ports, and urban infrastructure and services, are also essential.

Food security surfaced as a major development challenge in 2008. The sharp rise in global food prices and domestic crop losses due to natural disasters led to a surge in domestic food prices. Although quick action by the Government, through higher imports and public distribution of food supplies as well as expanded social safety net programs helped mitigate the hardship on the poor before prices eased, this episode signals the need to develop a preemptive strategy to deal with similar shocks in the future.

To maintain affordable food prices while providing fiscally sustainable incentives to farmers, agricultural productivity needs to be raised. Dissemination of new technologies, improved research and extension, and investments in rural infrastructure (including roads, water, and power), will help achieve greater productivity. The sustainability of safety net programs could be enhanced by linking such programs to rural infrastructure investments and other job-creating activities, thus more directly contributing to longer-term economic growth and poverty reduction.

The caretaker Government is credited with introducing core governance reforms to combat corruption and improve access to justice, and with implementing key institutional and sector reforms. Such progress, which was helped by the apolitical nature of the caretaker administration, will have to be sustained. The new Government will need to undertake further reforms in local governance, particularly decentralization of administration and finance, and build local government capacity, both to deliver services more effectively and to improve infrastructure.

3.15.1 Addressing climate change

Climate change is a pressing development challenge in view of the country's geographic location, low deltaic floodplain, and hydrological influence of erratic monsoon rainfall. The major climate-induced disasters, such as more frequent floods, cyclones, and storm surges, as well as droughts, are causing severe loss of life and damage to property, and are seriously affecting the country's development prospects. The damage to infrastructure is particularly costly, as it erodes productive capacity. It also reduces the security of livelihood assets for the poor.

A further rise in the sea level will make more areas of the country extremely vulnerable to floods, squeezing settlements and resource-use patterns, and will have serious implications for livelihoods and the physical environment. A rising sea level may also inundate vast areas of coastal Bangladesh and force millions of people to move.

In addition, a rising sea temperature is likely to make cyclones and storm surges more frequent. Finally, higher salinity intrusion in coastal areas and riverbank erosion across the country will severely affect the lives and livelihoods of millions of poor people.

The key challenges in tackling the effects of climate change are ensuring food and water security, protecting infrastructure, and managing disaster risks. Addressing health insecurity, forced migration, and overall environmental degradation is also vital. Aggravating any response are high population pressures, lack of funds for appropriate climate change adaptation measures, inadequate policy frameworks, and limited human resources.

Ultimately, climate change may threaten the significant gains made in poverty reduction over the past 20 years, and efforts to reduce poverty will only be sustainable over the longer term if they successfully incorporate climate change adaptation in development planning.

Bhutan

The economy is driven by hydropower project cycles. Significant new hydropower investment and output have contributed to rapid GDP growth in the past few years. For the next few years, the growth rate will slow before construction of new power plants lifts it again. Most power is exported to India under long-term contracts. Because of this, and the dominance of the power sector, the global economic slowdown is likely to have relatively little impact. However, the close trade and foreign exchange links to India, as well as a possible downturn in tourism, may still have an effect.

Economic performance

GDP growth in FY2008 (ended 30 June 2008) is estimated at 11.5%, down from 14.1% in the previous fiscal year (Figure 3.16.1). The phased commissioning of the 1,020 megawatt (MW) Tala hydropower station since July 2006 has tripled Bhutan's total power generation capacity to 1,480 MW (from 460 MW produced by three older power stations), boosting GDP growth sharply in FY2007 and slightly less in FY2008, due to the high base effect. Most hydropower is exported to India.

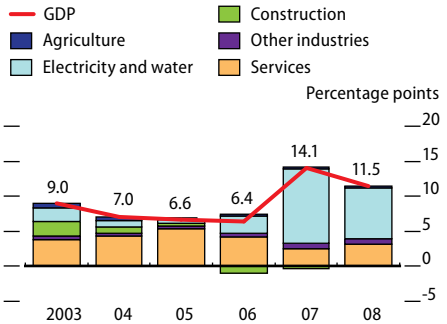
With its currency, the ngultrum, pegged to the Indian rupee (helping anchor inflation), and the country's close trade relationship with India (the source of 70% of imports), Bhutan's inflation moves along with India's. Mainly reflecting the increase in global commodity prices, the consumer price index in Bhutan escalated to 8.9% in the fourth quarter of FY2008, averaging 6.4% for all FY2008 (Figure 3.16.2). With the fall-off in global prices since mid-2008, inflation has likely peaked.

Money supply (M2) recorded modest growth of 2.3% in FY2008, compared with a 8.6% increase a year earlier. Credit to private sector, which dominates domestic credit, grew rapidly once more, at near 40%. The housing sector continued to have the highest share in bank loans (about 30%) reflecting the recent housing boom, followed by manufacturing (19%) and trade and commerce (18%).

Revised fiscal estimates for FY2008 show that nontax revenue was high, mainly from transfers of profits, tax, and dividends related to the Tala project, helping push total revenue to 37.8% of GDP (Figure 3.16.3). External borrowing (net of principal repayments) has been in a decreasing trend and turned negative in FY2008. Bhutan is taking pro-poor fiscal policy measures, according to which a third of expenditure is to be used for health and education (30% was achieved in FY2006 and FY2007). The Government has committed to maintaining its pro-poor policy in the use of additional resources.

The FY2009 budget set plans for greater expenditure (48.8% of GDP), which, however, does not include the additional costs of a 35% salary hike

3.16.1 Contributions to growth (supply)



Sources: Royal Monetary Authority, *Selected Economic Indicators*, Vol. 22, No. 2, June 2008; staff estimates.

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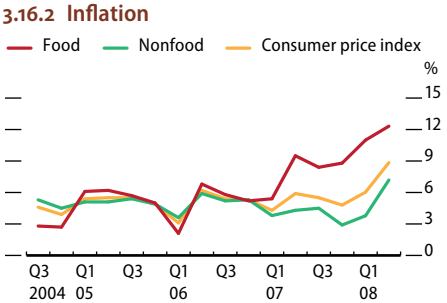
3.16.2 Inflation



Source: Royal Monetary Authority, *Selected Economic Indicators*, Vol. 22, No. 2, June 2008.

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This chapter was written by Tadateru Hayashi of the South Asia Department, ADB, Manila.

that was endorsed by the National Assembly in January 2009. With larger grants from India and increased receipts from hydropower projects, the government-budgeted deficit was projected to be 2.8% of GDP.

Total exports in the balance of payment are estimated to have decreased by 8.5% in FY2008, resulting in an unexpected trade deficit. The fall in exports appears to have resulted from a sharp drop in exports in January–June 2008. However, the latest available detailed customs data show a large increase in 2007 exports. Sales of electricity to India, which doubled in 2007, dominate Bhutan's total exports, with a share of 36% in 2007. Other major items are base metals (steel) exported to India (23% of total exports) and magnetic discs and cards sold to countries other than India (16%).

Tourism, an important source of hard currency, grew strongly up to June 2008 with visitor numbers rising by 32.4% and revenue by 29.8%. Because of the large current transfer inflow of budgetary grants from India (among others), the current account maintained a surplus, but one that declined to 3.9% of GDP (Figure 3.16.4). The overall balance of payments also stayed in surplus with a foreign direct investment inflow of $30 million (equivalent to 3.0% of GDP), including Tata Power's investment in a new hydropower project (Dagachhu). Gross international reserves stood at $646 million, equal to about 15 months of merchandise imports at end-FY2008.

Bhutan has a large external debt (relative both to other countries' and its own GDP), contracted mainly to finance hydropower projects. It stood at $780 million, or 58% of GDP, as of end-FY2008 (Figure 3.16.5). About 55% of debt is rupee-denominated borrowing from the Indian Government to support hydropower construction. The overall debt service ratio increased to 18% of total exports of goods and services in FY2008, reflecting the start of repayment for Tala. The bulk of Bhutan's external debt is self-sustaining, serviced by long-term power contracts with India, and with no foreign exchange risk. In addition, much of the remaining debt has been contracted on concessional terms. Thus the overall debt situation appears to be sustainable.

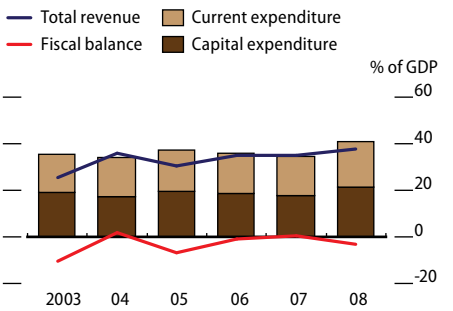
In the political sphere, Bhutan completed the transition from a monarchy to a two-party democracy. Elections were held for the National Council (the upper house) in December 2007 and for the first National Assembly (the lower house) in March 2008. The first written constitution was adopted in July 2008. The political situation under the new democratic system is expected to remain stable.

Economic prospects

Located in the Himalayas and close to India with its burgeoning demand for power, Bhutan is capitalizing on its huge untapped hydropower potential. The Government is planning four hydropower projects (Figure 3.16.6) with an aggregate generation capacity of about 2,900 MW for implementation during the 10th and 11th five-year plans (from FY2009 to FY2018).

Economic growth is therefore dominated by the hydropower project cycle. In FY2007 and FY2008, high growth was led by new electricity production from Tala. With Tala now at full output, GDP growth will

3.16.3 Fiscal indicators



Source: Royal Monetary Authority, *Selected Economic Indicators*, Vol. 22, No. 2, June 2008.

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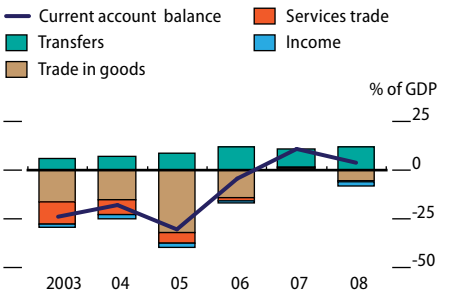
3.16.4 Current account indicators



Sources: Royal Monetary Authority, *Selected Economic Indicators*, Vol. 22, No. 2, June 2008; staff estimates.

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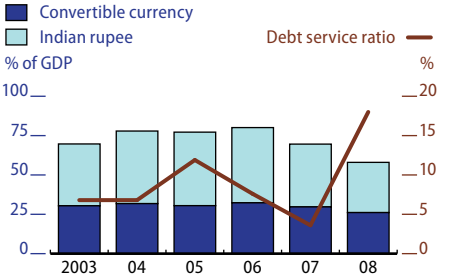
3.16.5 External debt indicators



Source: Royal Monetary Authority, *Annual Report 2007/08*, January 2009, available: http://www.rma.org.bt, downloaded 16 March 2009.

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come back to its normal path. Construction of new hydropower stations will gradually take over as drivers of growth.

Although these hydropower projects are unlikely to be directly affected by the global economic slowdown, some sectors have felt the chill wind. An early recovery cannot be expected for the steel industry, which benefits from cheap electricity, given the outlook for growth in India. Tourism is another sector that will likely suffer from the global slowdown. Moreover, some companies now face a lack of working capital because banks are reluctant to provide additional loans so as to avoid concentrating their lending among a few borrowers. Considering these factors, GDP growth is projected to be 5.5% and 6.5% in FY2009 and FY2010, respectively.

Inflation is projected at 3.5% and 4.0% for FY2009 and FY2010, respectively, similar to India's. A pay rise for Bhutan's civil servants could add to inflation pressures.

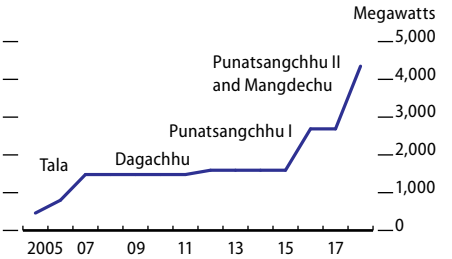
Although power exports to India will remain stable due to strong demand, exports of other products are expected to see only limited growth given the economic outlook in trade partner countries. Exports of services will also moderate as tourism weakens. The drop in international oil and other commodity prices will however help reduce imports. The current account surplus is projected at 5.5% of GDP for FY2009 and will further improve to 9.0% in FY2010.

3.16.1 Selected economic indicators (%)

	2009	2010
GDP growth	5.5	6.5
Inflation	3.5	4.0
Current account balance (share of GDP)	5.5	9.0

Source: Staff estimates.

3.16.6 Generation capacity



Sources: Gross National Happiness Commission, Royal Government of Bhutan, *Draft Tenth Five-Year Plan (2009–2013)*; staff estimates.

Click here for figure data

Development challenges

The 10th five-year plan targets full employment, particularly among educated youth, and emphasizes economic diversification, since hydropower employs few people and has few backward linkages. The unemployment rate rose to 3.7% in 2007 from 1.8% in 2003, and to help counter this, labor-intensive activities would be preferred—and tourism is one area where the private sector can expand. Private sector development will be a key focus, which would also diversify economic activity. The Government also needs to tackle some bottlenecks to investment activity, such as lack of skilled labor and limited financial sector outreach.

Bhutan is preparing to join the World Trade Organization this year. In the process, it has already agreed to open 54 out of 155 services. The 10th five-year plan committed to addressing the issue of skills shortages by providing vocational education and training. The Government has recently decided to approve new bank and insurance business licenses.

India

The Indian economy is facing major macroeconomic management challenges stemming from the global financial crisis. Declining private investment, dwindling capital inflows, shrinking foreign exchange reserves, weakening exports, and a depreciating rupee are some of the factors constraining high growth. The consolidated government deficit has reached a high level due to subsidies and fiscal stimuli. Resurgence in growth in the short run is contingent on economic recovery in the industrial economies and revival in business sentiment at home. Raising the growth trajectory in the long run requires completion of structural reforms and substantial investment in infrastructure.

Economic performance

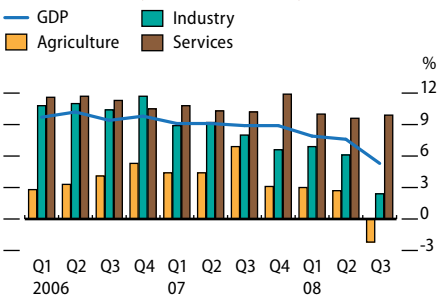
India went into FY2008 (ending March 2009) with strong macroeconomic fundamentals, although the authorities had serious concerns about high global prices of oil and other commodities pushing up domestic inflation. The possibility of a worsening of the international financial turmoil, which had surfaced in mid-2007 and deteriorated a year later, also posed a threat to maintaining the rapid pace of growth.

The financial crisis and global slowdown are affecting the economy through two main channels: capital flows and trade. The crisis prompted foreign institutional investors and banks to limit their exposure to emerging markets, undermining investment activity in India, while adding downward momentum to a slumping stock market. The slowdown in the global economy—with the United States (US), European Union, and Japan in recession—caused exports (including earnings from the information technology and business processing industries) to slump from October. The sum of these developments was economic growth falling sharply to 5.3% in the third quarter of FY2008 (Figure 3.17.1).

The Government's advance estimate for FY2008 put GDP growth at 7.1% as against 9.0% in FY2007 (Figure 3.17.2). (This outcome may be revised downward because of some uncertainty about end-year agricultural output.) At the sector level, industry accounted for about half the decline in growth in FY2008. Growing by only 4.8% (down from 8.1%), industry's deceleration reflected a sharp fall in growth in manufacturing (8.2% to 4.1%) and construction (10.1% to 6.5%) as private consumption and investment faltered. Expansion in the large services sector (over half of GDP) decelerated from 10.9% to 9.6%, that is, about one third of the total. Growth in agriculture slowed to 2.6% from 4.9% a year earlier, when output expanded above trend.

On the expenditure side, domestic demand is the primary growth driver (goods and services exports are about 25% of GDP). In FY2008, the pattern of domestic expenditure changed as the economy slowed (Figure 3.17.3). Growth in total consumption held pretty steady at just over

3.17.1 Quarterly GDP growth by sector



Note: Fiscal quarters.

Source: CEIC Data Company Ltd., downloaded 16 March 2009.

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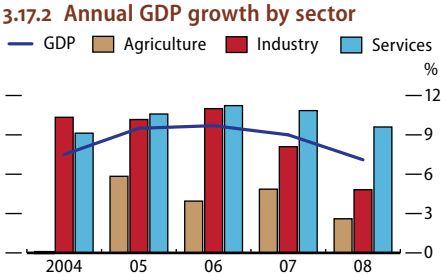
3.17.2 Annual GDP growth by sector



Source: Ministry of Statistics and Program Implementation, available: http://www.mospi.nic.in, downloaded 20 February 2009.

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This chapter was written by Shikha Jha of the Economics and Research Department, ADB, Manila; and Hiranya Mukhopadhyay of the India Resident Mission, ADB, Delhi.

8% but this masked a cooling in private consumption growth (from 8.5% to 6.8%), though government consumption expenditure growth more than doubled (from 7.4% to 16.8%) partly reflecting pay revisions of government employees.

Expansion in fixed investment, a major element of rapid growth in recent years, stepped down to 8.9% from 12.9% a year earlier. The weakness in investment, as well as an increased offset from net exports (reflecting a large expansion in import volume), were the main demand-side growth-inhibiting factors.

Wholesale price index inflation surged in the first 5 months of FY2008 to reach a high of 12.8% in August. It moderated over the following months (Figure 3.17.4), largely on weaker global prices for commodities and oil initially and later because the Government reduced the domestic prices of gasoline, diesel, and cooking gas in December 2008 and January 2009.

By February 2009 inflation was down to 3.6%, although food inflation remained stubbornly high (especially for rice, pulses, fruits and vegetables). A good spring harvest and high government food stocks are expected to add to the momentum of falling prices. Preliminary data for the first weeks in March indicate that year-on-year inflation has dropped to less than 1%, well below the authorities' target of 3%. Inflation for the whole of FY2008 is estimated at 8.7%, nearly double the previous year's 4.7%.

The concerns of the Reserve Bank of India (RBI) about inflation outweighed its anxieties over growth until September 2008, ensuring a tight monetary stance. Moreover, availability of credit was further constrained due to the knock-on effects of the global financial turmoil that resulted in reduced capital inflows. Coupled with the credit squeeze and high lending rates, increased input costs from higher commodity prices cut into manufacturing profitability and growth for much of FY2008.

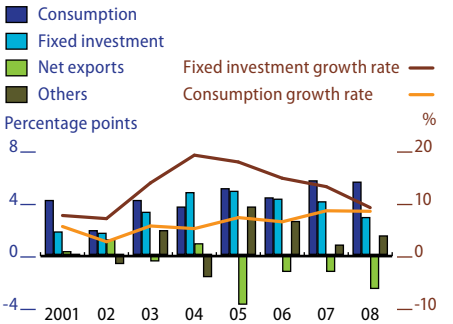
The moderating inflation provided an opportunity for RBI, from October, to reverse its stance and initiate expansionary credit policies. In phases it lowered the banks' cash-reserve ratio from 9.0% to 5.0%, the repo rate from 9.0% to 5.0%, and the reverse repo rate from 6.0% to 3.5% through early March (Figure 3.17.5).

Despite these reductions, local banks were reluctant to lower their lending rates significantly because of the high cost of the term deposits on their books; a downward floor of bank deposit rates due to interest rate paid on the Government's small-savings schemes; worries about a likely increase in nonperforming loans; and a riskier business environment for firms.

Still, with prompting from RBI, banks have lowered the prime lending rate by about 100 basis points to between 13% and 15%, but even then, tumbling inflation means that real interest rates have risen such that the stickiness of high bank lending rates has become a major concern for business. Bank lending has not expanded after the policy easing, even though banks had large excess reserves (Figure 3.17.6). General credit availability has probably tightened as capital inflows were—apparently—much lower after September.

RBI's measures to boost capital inflows included relaxation of restrictions on external commercial borrowings, abolition of interest

3.17.3 Contributions to growth (demand) and growth rates



Sources: CEIC Data Company Ltd., downloaded 16 March 2009; Press Information Bureau, Government of India, *Press Note*, 9 February 2009.

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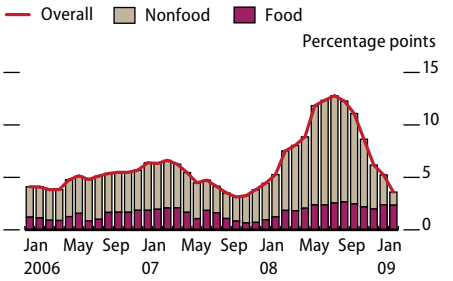
3.17.4 Contributions to wholesale price inflation



Source: CEIC Data Company Ltd., downloaded 16 March 2009.

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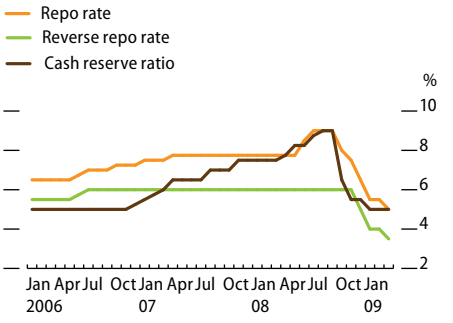
3.17.5 Policy intruments



Source: Reserve Bank of India, available: http://www.rbi.org.in, downloaded 16 March 2009.

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rate ceilings on borrowing, and increasing the annual limit on foreign institutional investment in rupee-denominated corporate bonds to $15 billion. RBI also took measures to increase the availability of credit for exporters and housing as well to small enterprises.

The current financial and economic crisis has derailed the central Government's post-FY2004 process of fiscal consolidation. The Government announced in the period December 2008 through February 2009 several fiscal stimulus measures to spur domestic demand, which amounted to about 1.5% of GDP. It made available additional funds for critical rural infrastructure and social security programs, and authorized Rs100 billion of tax-free bonds for financing public–private infrastructure projects.

It made, in December, a general 4 percentage point cut of the central value-added tax rate (excluding petroleum products). For certain goods, it cut that rate by a further 2 percentage points in late February; at the same time, it lowered the service tax by this amount. Exporters will receive full refund of service tax paid in with respect to their shipments. Moreover, the central Government raised the borrowing limit for state governments from 3.0% to 3.5% of state GDP.

The fiscal responsibility law has been put aside temporarily and the central government budget deficit is estimated at 6.0% of GDP as against 2.5% targeted for FY2008 (Figure 3.17.7). Revenue grew by only 3.7% with shortfalls from corporate taxes and import duties, well below the near 25% gain in previous years.

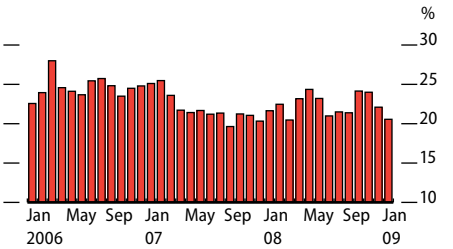
On-budget expenditure increased by about one third, because of additional social spending and subsidies, a large pay hike for civil servants stemming from the Sixth Central Pay Commission recommendations, and greater than budgeted capital expenditure. Despite falling prices toward the end of the year, off-budget subsidies for fuel and fertilizer amounted to 1.8% of GDP in FY2008. Including off-budget items, central government expenditure amounted to 18.2% of GDP, bringing the deficit to 7.8% of GDP. The high fiscal deficit has led Standard & Poor's to downgrade India's long-term sovereign debt outlook from "stable" to "negative," though the country retained a BBB- rating.

State governments have already brought down their deficits to under the target of 3.0% of state GDP set under their fiscal responsibility laws. Sustaining this pace will remain difficult though, because receipts of shared taxes from the central Government are likely to decline over the next few years. If, as expected, the consolidated states' deficit amounts to about 2.2% of GDP in FY2008, the general government deficit for the year would amount to 10% of GDP (including the off-budget items), fully reversing the fiscal adjustment of the past 6 years.

A full budget for FY2009 will be prepared after a new government is formed, subsequent to the national elections in April and May. The interim budget for FY2009 announced by the Government in February envisages an 8.4% increase in revenue and a 15.7% expansion in expenditure resulting in a fiscal deficit of 5.5% of GDP. With low global prices, the interim budget did not foresee the need for off-budget oil or fertilizer subsidies. The interim budget proposed no new tax measures as the new government will formulate fiscal policy for the year.

Better targeting of food and fertilizer subsidies and improved

3.17.6 Commercial bank lending growth



Source: CEIC Data Company Ltd., downloaded 16 March 2009.

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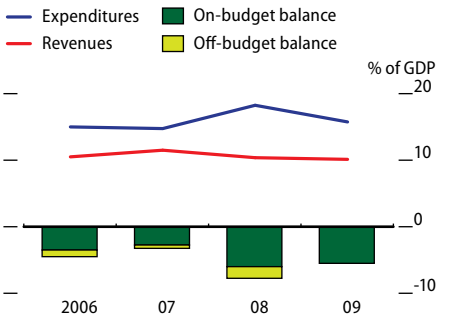
3.17.7 Central government fiscal indicators



Source: Ministry of Finance, available: http://indiabudget.nic.in/, downloaded 16 March 2009.

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cost recovery by oil-marketing companies and refineries have become imperative for sustaining fiscal deficit. At a time of falling business confidence, expansionary fiscal policies could impair the confidence of investors unless clear signals are given that the present large deficits are truly temporary. General government debt is estimated to be 80.7% of GDP at end-FY2008, indicating little room for fiscal maneuver.

The weak performance of exports—declining year on year since October 2008—have compounded the challenges of macroeconomic management (Figure 3.17.8). Exports in January 2009 amounted to $12.4 billion, or 15.9% lower than a year earlier. Items such as textiles, readymade garments, gems and jewelry, and petroleum products all saw declines. Deepening recession in industrial countries is affecting India's exports of information technology and business services, too.

Depreciation of the rupee in FY2008 does not appear to have had a favorable impact on export sales in view of external demand conditions but it has helped preserve firms' profit margins. Recently, India has been seeking to expand export sales beyond its traditional markets to the Middle East, Singapore, and other emerging markets through product diversification and quality improvement. Expansion of exports to PRC that began in earnest in the first half of FY2008 weakened in the second.

Import growth since October has dropped markedly from earlier months, reflecting a fall in oil imports and a modest increase in non-oil imports (Figure 3.17.9). At $18.5 billion in January 2009, imports were 18.2% below the level of a year earlier.

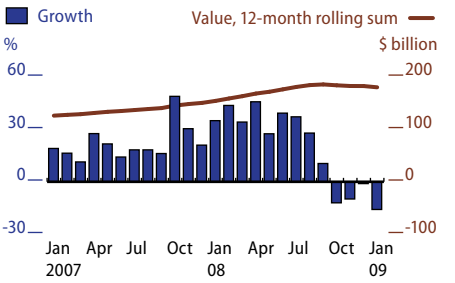
For FY2008, exports (on a balance-of-payments basis) are estimated to have reached $186 billion (a 12.1% advance over a year earlier), and imports $298 billion (15.6%). The current account deficit, put at $22.3 billion in April–September 2008 by RBI, is estimated at $35 billion (3.0% of GDP) for all FY2008, compared to a $17.0 billion deficit (1.5% of GDP) a year earlier.

The main impact of the global financial turmoil on India is the significant change in the capital account. In the first 6 months of FY2008 (March–September), central bank data showed heavy portfolio investment net outflows of $5.5 billion compared to net inflows of $18.4 billion in the year-earlier period. Similarly, commercial borrowing by the private sector slowed to $3.3 billion from $11.2 billion previously. Foreign direct investment (FDI), however, remained buoyant at $20.7 billion during the first half of FY2008 (from $12.2 billion) reflecting the continued expansion of domestic activities, a more positive investment climate, and continuing liberalization measures to attract FDI.

Net capital inflows in the first half of FY2008 came to about $20 billion, or only about 40% of the amount attracted a year earlier. The second half looks like being much weaker. Rough estimates suggest that net capital inflows tumbled in FY2008 to less than one fifth of the $108 billion recorded in FY2007.

With a weakening capital account and larger foreign exchange requirements for imports, especially for oil and fertilizer, there was downward pressure on the rupee despite central bank intervention. The rupee depreciated by about 21% against the US dollar between end-March 2008 and end-February 2009 (Figure 3.17.10). The real effective exchange rate also depreciated by about 7% during this period. Foreign currency

3.17.8 Export indicators



Sources: CEIC Data Company Ltd., downloaded 16 March 2009; staff estimates.

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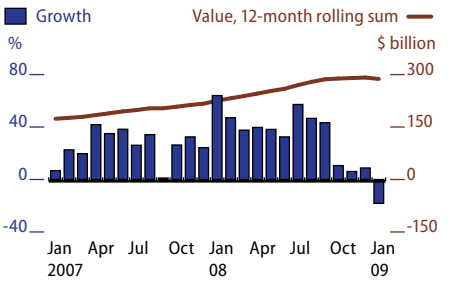
3.17.9 Import indicators



Source: CEIC Data Company Ltd., downloaded 16 March 2009; staff estimates.

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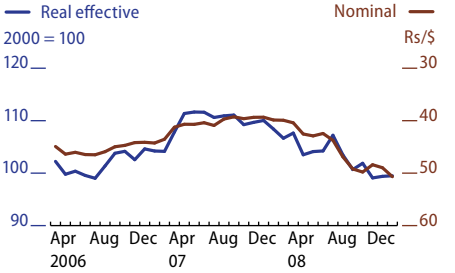
3.17.10 Exchange rates



Sources: CEIC Data Company Ltd.; Bank for International Settlements, available: www.bis.org; both downloaded 16 March 2009.

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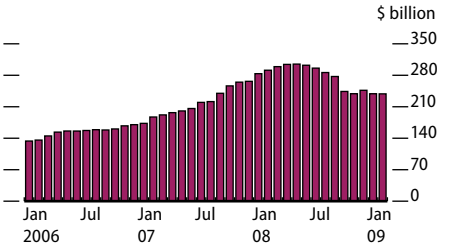
assets of the RBI declined from about $300 billion at end-March 2008 (Figure 3.17.11) to $237 billion on 6 March 2009.

The Sensex, the main index of the Bombay Stock Exchange, has fallen by about 58% from its all-time high in early January 2008 through mid-March 2009. This drop follows a substantial runup in recent years. Developments in the Sensex are broadly in line with other markets in Asia (Figure 3.17.12), and generally reflect the global financial market turmoil, loss of foreign investor interest, and uncertain economic outlook both in India and in other Asian countries. Market capitalization has fallen from a peak of about 140% of GDP in December 2007 to about 50% of GDP in February 2009. Since stocks are often used as collateral by entrepreneurs for new business loans at banks, the large loss in value has had a depressing effect on new ventures.

Business confidence indicators capturing the financial position of firms, current investment climate, and capacity utilization show continued decline (Figure 3.17.13). Falling confidence has been felt across the spectrum of services and industry, largely because of uncertainties for the global economy and worries about the cost and availability of borrowing. Declining input costs have so far been unable to lift the gloomy business sentiment. Most large companies recorded a fall in net profit due to declines in sales and prices.

As companies scale back production, millions of workers have been laid off or have accepted shorter working hours and lower wages. Those particularly affected include a large number of workers in export-oriented sectors such as textiles or gems and jewelry. Job losses are also multiplying in sectors supporting domestic demand, such as motor vehicles, tourism, and transport services. New employment opportunities have dried up in urban areas and are also showing signs of falling in rural areas. The lack of a well-developed social safety net and rigid labor laws put millions of people in the informal sector at risk of falling into poverty.

3.17.11 Foreign currency assets



Sources: CEIC Data Company Ltd.; Reserve Bank of India, *Weekly Statistical Supplement*, available: www.rbi.org, both downloaded 12 March 2009.

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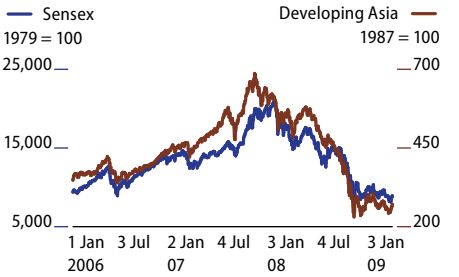
3.17.12 Stock price indexes



Note: The Developing Asia index is represented by the Morgan Stanley Capital International All Country Asia excluding Japan price index.

Source: Bloomberg, downloaded 16 March 2009.

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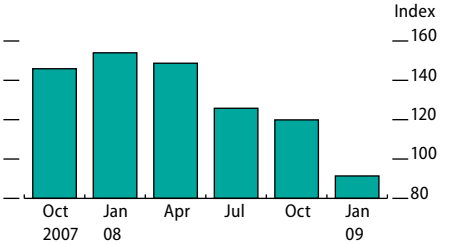
Economic prospects

The global economic outlook has turned increasingly gloomier in the last 6 months. Industrial countries have gone into recession, worldwide demand is drying up, and international oil and commodity prices have plummeted. India's growth has slowed significantly, domestic price pressures have subsided, and inflation has sunk almost out of sight. On the policy front, monetary tightening has given way to monetary easing. With little room for further fiscal maneuver and with inflation largely in abeyance, it is monetary policy that will have to revive growth in the short run.

The forecasts for FY2009 and FY2010 are based on five key assumptions: monetary conditions will continue to be accommodative; domestic food supply position will remain comfortable; global oil prices will average $43 a barrel in 2009 and $50 a barrel in 2010; nonfuel commodity prices will decline in 2009, but rise marginally in 2010; and a recovery in industrial economies will begin in the second quarter of FY2010.

Surplus food stocks and a normal monsoon would keep the agricultural situation comfortable. But industry and services will continue

3.17.13 Business confidence index



Source: National Council of Applied Economic Research, available: www.ncaer.org, downloaded 16 March 2009.

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to suffer in the immediate uncertain environment. Consumers as well as entrepreneurs will probably be reluctant to borrow, either to spend or to invest. Prolonged recession in industrial countries will keep investor confidence low. Banks will maintain a risk-averse strategy, especially given a likely deterioration in the quality of loans. As consumer sentiment drops and job losses mount, an immediate revival in demand for consumer durables, motor vehicles, and housing is unlikely. Substantial excess capacity in domestic industry and limited export demand are damping investment prospects.

GDP growth is projected to decline to 5.0% in FY2009. Enhanced public spending, tax cuts, and increases in public sector wages are expected to buttress growth. In FY2010, a combination of a recovery in the G3 economies, improved perception of lower risks of investing in India, and lower domestic lending rates is expected to facilitate some recovery in private investment and manufacturing growth. These changes will support gradual recovery in growth to 6.5% (Figure 3.17.14).

Temporary fiscal stimulus can help prop up economic activity in the difficult period ahead, but it is imperative that the central Government bring down its deficit in the medium term to a manageable level so as to assure long-term debt sustainability. The Government therefore needs to review tax policy, the quality of public expenditure, and the effectiveness of public programs. This will allow it to create space for the infrastructure and social sector spending necessary for achieving rapid inclusive growth. Fiscal consolidation would benefit if the central Government were to set new fiscal policy rules, adopt fuel pricing and subsidy reforms, and abolish all off-budget spending.

Inflation is expected to remain low during FY2009 and FY2010 with comfortable agricultural output, especially of foodgrains, weak domestic demand, lower taxes on goods, and a decline in global commodity prices. Inflation is forecast at 3.5% in FY2009, and to rise a little to 4.0% in FY2010 as domestic markets recover and international prices of oil and non-oil commodities edge up.

Capital inflows will remain under stress throughout FY2009. A weakening capital account will put pressure on the Indian rupee to depreciate. Contraction in world trade volume will prevail over the favorable impact of the real exchange rate depreciation. In FY2009, a fall of about 10% in exports and imports, since imports are larger than exports, will improve the trade and current account deficits. An upturn in export growth in FY2010 is contingent on a recovery in world trade. A gradual rise in international oil and non-oil commodity prices will boost import growth and the trade deficit. The current account deficit is projected to narrow to 1.5% of GDP in FY2009 but then widen a little to 2.0% the following year.

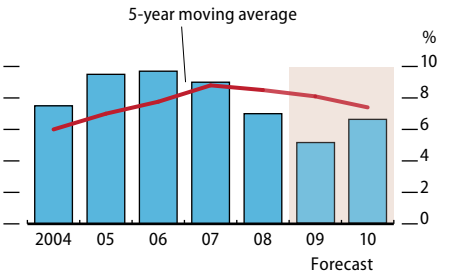
One downside risk that may jeopardize growth prospects is excessively large fiscal deficits, with domestic borrowing requirements of the Government putting pressure on interest rates and restricting the availability of private credit and investment. A further risk is continued recession in industrial countries beyond the second quarter of FY2010. In such an event growth would falter, further structural reforms would be difficult, and policy would likely look inward, which could undermine long-term growth prospects.

3.17.1 Selected economic indicators (%)

	2009	2010
GDP growth	5.0	6.5
Inflation	3.5	4.0
Current account balance (share of GDP)	-1.5	-2.0

Source: Staff estimates.

3.17.14 GDP growth



Sources: Reserve Bank of India, available: http://www.rbi.org.in, downloaded 20 February 2009; staff estimates.

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Maldives

As a small import-dependent economy with a narrow economic base of tourism and fishing, the Maldives is particularly vulnerable to external shocks. High global commodity prices caused a spike in inflation and widened the current account deficit in 2008, and the global economic slowdown hit tourist arrivals. These developments added to the pressures induced by an overly expansive post-2004 fiscal policy. The newly elected president plans to introduce structural reforms to bring down the large domestic and external imbalances. The bleak global economic outlook presents substantial headwinds and risks.

Economic performance

A slowdown in tourism, which generates about a third of GDP, was the main cause for the fall in growth to 5.7% in 2008 from 7.2% a year earlier (Figure 3.18.1). Value added in tourism fell to 2.9% growth from 9.4% in the previous year. Tourist arrivals edged up by only 1%, or well below the 12.3% expansion in 2007, reflecting the slowdown in the second half of the year (Figure 3.18.2). Arrivals from Europe, a market that accounts for more than 70% of arrivals, climbed marginally (0.4%). This mirrored the deteriorating economic conditions there and the euro's weakening against the United States (US) dollar (the rufiyaa is pegged to the dollar) in the last quarter of 2008.

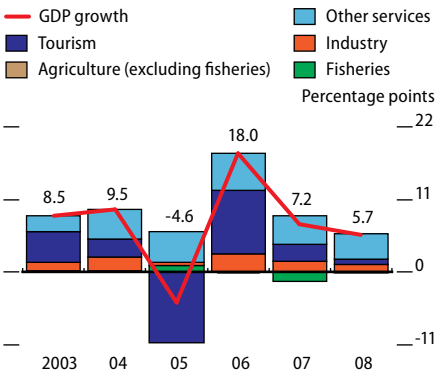
Value added in fisheries, which contributes only 4.2% of GDP but is important in terms of employment and merchandise exports, contracted by 2.7% in 2008 on a reduction in the fish catch, though fish exports grew by about 17%, on better prices. Growth in industry—manufacturing, utilities, and construction—slowed but its share in GDP increased slightly to 17.7%.

In an adverse external environment, inflation, as measured by the national consumer price index, rose to an average of 12.3% in 2008 from 7.4% a year earlier. Inflation broadly follows the movement of international prices, as the country imports the bulk of the commodities it consumes. Food, petroleum products, and construction materials are major items. Paralleling international price trends, inflation began to pick up in the second half of 2007 and peaked at 17.3% year on year in July 2008, before moderating to 9.1% in December (Figure 3.18.3).

Money supply growth gradually slowed to 23.6% year on year in December (Figure 3.18.4). The impact of expansion in domestic assets of over 40% was, however, partly offset by changes in net foreign assets of the banking system, the net liabilities of which have been growing since July 2007. This increase reflects the borrowing by foreign-owned commercial banks from their headquarters to lend to the private sector. More than half the outstanding bank credit is related to tourism.

The deteriorating fiscal balance is a concern. The Government

3.18.1 Contributions to growth (supply)



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 10, No. 1, February 2009.

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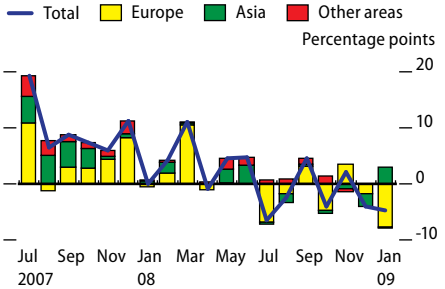
3.18.2 Contributions to growth in tourist arrivals



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 10, No. 2, February 2009.

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This chapter was written by Tadateru Hayashi of the South Asia Department, ADB, Manila.

included large reconstruction outlays in the budget after the tsunami in December 2004, but also pushed up current spending, both to raise public sector wages and to maintain power and water subsidies in Malé. In 2008, it faced revenue and foreign exchange shortfalls, leading to the non-award of two planned major infrastructure projects totaling $190 million. The Government wanted to fill the revenue gap with leases for new resorts on 30 islands, as well as a 20% reduction in budgeted expenditure for the last few months of 2008. It did not, however, proceed with the lease tenders and instead found alternative sources from bilateral and commercial external sources. Expenditure for 2008 is estimated at 67.0% of GDP, up slightly from 66.1% in 2007. The fiscal deficit worsened to 15.7% of GDP in 2008 from 7.9% (Figure 3.18.5).

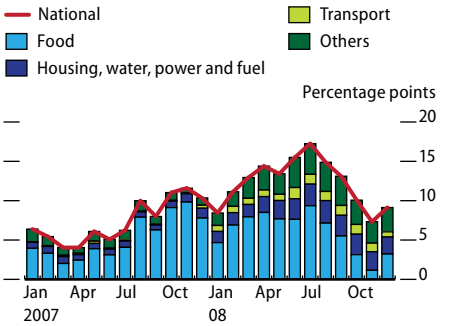
The jump in public debt from around 40% of GDP in 1999 to around 57% in 2008 raises serious sustainability concerns. About 70% of outstanding public debt is foreign currency denominated. The large deficit buildup underscores the need for fiscal prudence and for fiscal consolidation to reduce the vulnerability of the balance of payments. For example, the tax base should be expanded as it is currently reliant almost exclusively on import duties and tourism receipts. A business profit tax and a more progressive tourism tax would help secure more stable receipts.

The external sector has also experienced widening imbalances. Higher international commodity prices raised the import bill by almost one third in 2008, in large part due to the nearly 40% weight of food and petroleum products in total imports. With modest growth in domestic exports (5.5%), the trade deficit deteriorated by about 26% to $928 million, or 74% of GDP. The net surplus in services expanded by about 4% only, reflecting moderate growth in tourism receipts and larger services imports. The current account deficit widened sharply to $637 million (about 50.6% of GDP), from 39.1% in 2007 (Figure 3.18.6). Although the financial account continued to record large net inflows, the overall balance of payments moved into deficit (of $72.3 million) in 2008. At year-end, gross international reserves stood at $241 million, or 2.1 months of imports.

Short-term external debt (all owed by commercial banks) has surged since 2005 to 39.5% of GDP. Because the bulk of commercial bank lending is to develop tourism, the banks probably face a risk of asset–liability term mismatch, and as the global financial crisis deepens, they may find it hard to roll over short-term borrowing. The external imbalance thus poses significant risks for the balance of payments as well as for financial institutions' balance sheets.

The country went through an important political transition in 2008. A new constitution was adopted in August, followed by the first multiparty presidential election in November, which brought in a new president—the first for 30 years. The new Government faces hard choices to mitigate immediate risks of the country's macroeconomic imbalances. Unless it rationalizes its spending and, in particular, curtails power subsidies, public debt may not stay sustainable. More generally, the Government's ability to promptly carry out its development priorities will to a large extent depend on it success in addressing domestic and external imbalances.

3.18.3 Inflation



Source: Maldives Monetary Authority, *Monthly Statistics*, various issues.

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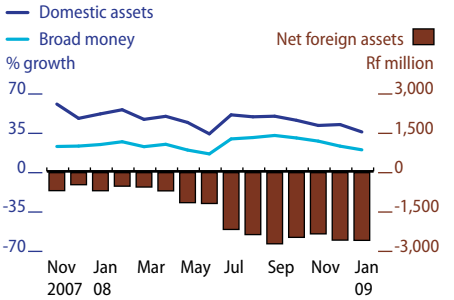
3.18.4 Monetary indicators



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 10, No. 2, February 2009.

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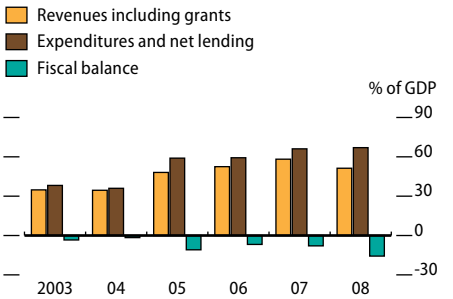
3.18.5 Fiscal indicators



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 10, No. 2, February 2009.

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Economic prospects

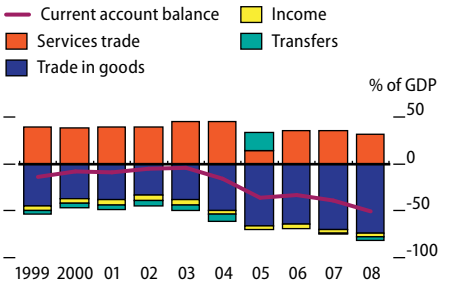
The GDP projection heavily depends on the new administration's ability to introduce meaningful economic reforms. Parliamentary elections in the first half of 2009 are expected to pave the way for measures to address the large internal and external imbalances. Growth in 2009 will also depend on the depth of the tourism tumble. Although the Government is promoting tourism from areas other than Europe, such as India, and despite likely room-rate discounts, tourist arrivals are expected to fall this year. On these assumptions, economic growth is projected to decelerate to 1.0% in 2009 and gradually recover to 1.5% in 2010.

Inflation is put at 4.5% and 5.5% in 2009 and 2010, broadly in line with global price assumptions but reflecting February 2009's pay rise for government employees of 25–30%. It is also assumed that the monetary authority will not monetize a part of the government fiscal deficit. On the external front, lower commodity prices will ease the trade deficit, but receipts from tourism will recover only after 2010. The current account deficit is forecast to be about 30.0% of GDP in both 2009 and 2010.

For the medium term, the Government will consider downsizing public employment as well as making tax reforms (such as introducing a business profit tax, an ad valorem tourism tax, and eventually a general sales tax). Amendments to the Tourism Act are expected to provide additional resources from an extension of the resort lease period.

Although the new Government's policy intentions are in the right direction, fiscal consolidation may face challenges due to the economic slowdown as fiscal receipts, especially from tourism, come under strain. Time, however, is of the essence, as the large fiscal deficit is exerting significant pressure on the balance of payments.

3.18.6 Current account



Source: Maldives Monetary Authority, *Monthly Statistics*, Vol. 10, No. 2, February 2009.

Click here for figure data

3.18.1 Selected economic indicators (%)

	2009	2010
GDP growth	1.0	1.5
Inflation	4.5	5.5
Current account balance (share of GDP)	-30.0	-30.0

Source: Staff estimates.

Development challenges

The country needs to address its shortage of skills and weak institutional capacity. Since vocational and skills training is underdeveloped, the education system does not provide the kind of workers that the labor market requires. High youth unemployment and heavy reliance on expatriate workers are a consequence.

The Government still plays a large role in the economy through state enterprises, indirectly limiting scope for private sector activity. Public ownership is widespread in every sector except tourism. One of the new Government's priorities is privatization, as seen in the advanced stage of turning over Malé International Airport to the private sector. The Government is also seeking expressions of interest in other entities, including state fisheries and electricity companies.

Income disparities between Malé and the atolls are large and widening. The Gini coefficient for the whole country was 0.41 in 2004, pointing to significantly higher inequality than in neighboring countries. Ensuring inclusive growth is thus vital. The Government also aims to prioritize decentralization, shifting the focus of economic development from Malé and creating economic and social infrastructure away from the capital.

Nepal

Economic growth rebounded in FY2008 from a slump in FY2007, aided by an improved security situation and emerging political stability following the end of the decade-long civil conflict, and by favorable weather. Sustaining this growth and the poverty-reduction gains of the past decade will, though, remain challenging given the protracted and complex post-conflict political transition. Additionally, the downdraft from the deepening global downturn could damage the country's growth prospects to a greater extent than earlier expected.

Economic performance

Nepal's peace process took a key step forward with the orderly conduct of the historic constituent assembly elections in April 2008, which raised hopes of economic recovery and improved living standards. Although the election results were not decisive enough to usher in a majority government, the Communist Party of Nepal, Maoist (CPNM)—an insurgent political force until April 2006—emerged as the largest party in the constituent assembly, giving it the lead role in the new coalition Government formed in August. The new administration envisages an ambitious economic recovery and development agenda in the difficult transitional political environment.

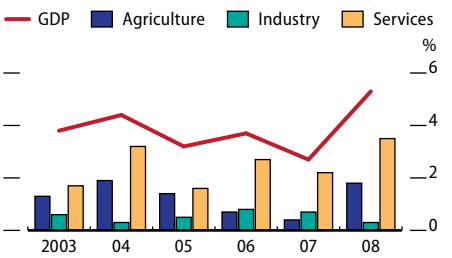
Aided by the improved security situation, overall GDP growth went back up to 5.3% in FY2008 (ended mid-July 2008) from 2.7% in FY2007 (Figure 3.19.1). This rebound, which reflected the sustained expansion of services and a weather-induced recovery in agriculture, could have been greater had it not been for the deceleration of industry due to input supply disruptions and labor agitation.

Services, with a 48% share in overall GDP (Figure 3.19.2), expanded by 7.0%, contributing 3.6 percentage points to overall growth (Figure 3.19.1 above). Growth was broad-based within the sector. In particular, hotels and restaurants as well as financial intermediation, which grew by 8.5% and 13.8%, respectively, benefited most from a sustained increase in tourist arrivals and the entry of new financial institutions. Real estate–related businesses, however, decelerated to 4.4% from 11.8% growth in FY2007, as rural households displaced by the conflict started to return from urban areas to their homes.

Agriculture, with a 36% share in overall GDP, also registered strong growth of 4.7%, underpinned by a significant increase in paddy and other crop output, which was aided by favorable monsoon rains. Agriculture's contribution to GDP growth in FY2008 improved to 1.8 percentage points, from only 0.4 percentage points in FY2007.

Industrial growth, however, slackened to 1.9% in FY2008 from 3.9% in the previous year—a combined effect of long-standing structural weaknesses, such as low productivity and the inadequate infrastructure

3.19.1 Contributions to growth (supply)



Source: Ministry of Finance, available: http://www.mof.gov.np, downloaded 9 March 2009.

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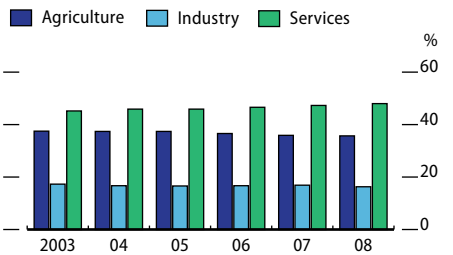
3.19.2 Sector shares of GDP



Source: Ministry of Finance, available: http://www.mof.gov.np, downloaded 9 March 2009.

Click here for figure data

This chapter was written by Raju Tuladhar and Yubraj Acharya of the Nepal Resident Mission, ADB, Kathmandu.

base, as well as disruptions caused by growing labor unrest and acute power and fuel shortages. (The power shortages are due to additional peace-time demand and low water levels in reservoirs.) Although manufacturing was hard hit by these disruptions, construction activities continued to grow moderately.

On the demand side, the economy continued to be driven by private consumption, in turn fueled by workers' remittances. However, private consumption's share declined marginally to about 77% of GDP as investment picked up—gross fixed capital formation increased to 21.1% of GDP from 20.4% in the previous year—in response to the improved security situation and emerging political stability.

Average consumer inflation rose to 7.7% in FY2008 from 6.4% a year earlier, mainly reflecting rising fuel and food prices and the higher inflation in India. Nepal's inflation is closely linked to India's, given the currency peg to the Indian rupee, close trade ties, and the open border. Inflation rose to 12.1% on a 12-month basis by July and remained high through mid-January 2009 (Figure 3.19.3). Steeper transport costs that reflected fuel price adjustments, and a shortage of rice partly caused by India's temporary export ban, contributed to the increase in food prices. Given the hike in food prices (which make up 53% of the consumer price index basket), inflation has imposed a particular hardship on the poor.

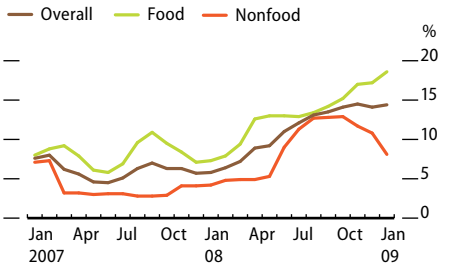
The central bank kept its main policy (bank) rate unchanged at 6.25% and the cash-reserve ratio at 5.0% in FY2008. A sharp rise in net foreign assets during the year, generated by stronger remittance inflows, expanded banking system liquidity and raised reserve money by 21.2%, compared with 7.5% in FY2007. This led to a 25.2% expansion in broad money (M2), up from 14.0% in FY2007. To rein in rising inflation, the central bank adopted a tighter monetary policy for FY2009 by lifting the bank rate to 6.5% and the cash-reserve ratio to 5.5%.

Improved revenue mobilization helped contain the budget deficit at 2.0% of GDP (1.8% a year earlier) despite a surge in expenditure (Figure 3.19.4). Recurrent spending swelled by nearly 19%, mainly on account of peace process–related expenditures such as the constituent assembly elections and operation of the temporary camps for former CPNM combatants until they are integrated into society. Capital spending also jumped, by 40.5%, in an improved project implementation environment. Total revenue (including taxes, nontax revenue, and grants) grew robustly by 24.5% in FY2008—even after sturdy growth of 21.2% a year earlier—supported by stronger tax administration. It increased to 15.6% of GDP, a gain of about 1.5 percentage points from a year earlier.

The improved security and political situation facilitated increased use of external assistance (both grants and loans), although spending still fell short of the budget target. The lower than budgeted fiscal deficit helped contain domestic financing at the budgeted level of 1.6% of GDP.

On the external front, the current account in FY2008 moved to a surplus of 2.6% of GDP from a deficit of 0.1% a year earlier, buoyed by large workers' remittances (17.4% of GDP) and improved tourism receipts (2.3% of GDP), which more than offset a widening trade deficit (Figure 3.19.5). Export growth picked up to 12.8% (from 1.9% in FY2007), because of a significant rise in shipments to markets other than India. Still, the trade deficit widened by about 2 percentage points to 19.2%

3.19.3 Inflation



Source: Nepal Rastra Bank, available: http://www.nrb.org.np, downloaded 24 February 2009.

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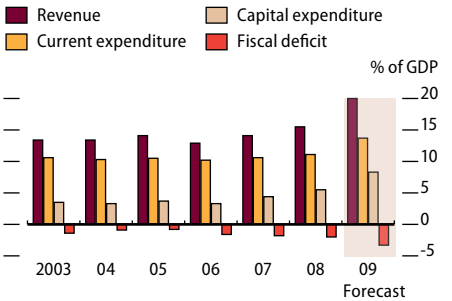
3.19.4 Fiscal indicators



Sources: Ministry of Finance, available: http://www.mof.gov.np; Nepal Rastra Bank, available: http://www.nrb.org.np, downloaded 24 February 2009.

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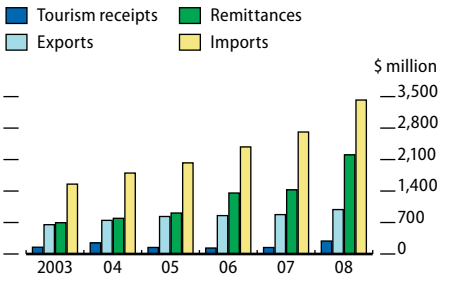
3.19.5 Trade, tourism, and workers' remittances



Source: Nepal Rastra Bank, available: http://www.nrb.org.np, downloaded 24 February 2009.

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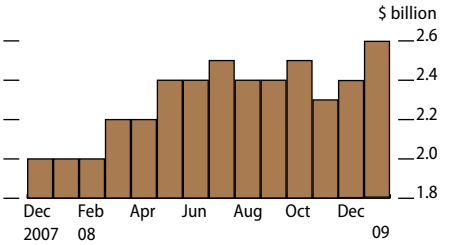
of GDP as imports surged by 26.3%, fueled mainly by large remittance spending on consumer goods and by higher oil prices.

With increased aid flows, the overall balance-of-payments surplus grew to 4.1% of GDP. Foreign exchange reserves climbed markedly to $2.5 billion at end-FY2008 (mid-July), and subsequently rose to $2.6 billion by mid-January 2009 (Figure 3.19.6). Reserves are equivalent to about 7 months of imports of goods and services.

The Nepalese rupee depreciated by 5.3% against the United States dollar over the course of FY2008 due to its peg to the Indian rupee (Figure 3.19.7). The trade-weighted real effective exchange rate also depreciated, by 3.4%.

3.19.6 Foreign exchange reserves



Source: Nepal Rastra Bank, available: http://www.nrb.org.np, downloaded 24 February 2009.

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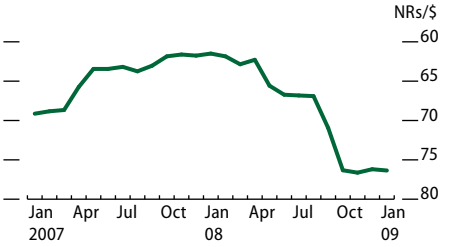
Economic prospects

Medium-term growth and development prospects rest largely on continued macroeconomic stability, a smooth and rapid political transition, and the impact of the global economic slowdown. The fragile political situation and the adverse external environment pose significant downside risks. The expansionary FY2009 budget—with an expenditure outlay of NRs218.6 billion or a 52.0% increase from the estimated expenditure in FY2008—presents a challenge for maintaining fiscal and macroeconomic stability.

The more disruptive is the post-conflict political transition, the less focus will there be on the pressing reform and development priorities. A rapid political transition, in parallel with renewed structural reform and development efforts to boost rural incomes, is therefore vital. Although the global economic slowdown has not yet affected Nepal, some impact is inevitable on exports, remittances, tourism receipts, and external assistance, especially if it is prolonged. The authorities will, therefore, need to remain vigilant and be prepared to take necessary fiscal and monetary policy measures.

3.19.7 Exchange rate



Source: International Monetary Fund, *International Financial Statistics* online database, available: http://www.imfstatistics.org, downloaded 2 March 2009.

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Lower international oil prices augur well, as the economy is fully dependent on imported fuel. An upswing in oil prices could, though, once more disrupt supply, which combined with power shortages would have a detrimental impact. Current low international oil prices present an opportunity to put in place an effective market-oriented pricing mechanism and import deregulation.

Against this backdrop, the baseline assumptions for Nepal's economic performance in FY2009 and FY2010 are that normal weather conditions will prevail, the political transition will progress without serious disruption, prudent macroeconomic policies will be continued, and business confidence will strengthen somewhat. It is also assumed that the exchange rate peg to the Indian rupee will be maintained and that the domestic oil supply situation will remain normal, but that power shortages will not ease significantly.

Based on these assumptions, GDP growth is forecast to slow to 3.0% in FY2009, following the high cyclical rebound in services and the exceptional gain in agriculture in FY2008, and then pick up somewhat to 3.5% in FY2010. Growth in each of these 2 years will be led by a 4.0% expansion in services.

Services growth in FY2009 will be supported by trade, financial

3.19.1 Selected economic indicators (%)

	2009	2010
GDP growth	3.0	3.5
Inflation	10.0	8.0
Current account balance (share of GDP)	1.5	1.0

Source: Staff estimates.

intermediation, transport and communications, and tourism (though the likely significant shortfall in the Government's capital spending due to delayed budget approval will limit growth in certain subsectors). Financial expansion will be aided by the new Government's efforts to boost rural financial services, while the expansion of transport and communications, and of tourism, will be bolstered by improved fuel supply.

Although the growth of some subsectors such as trade and tourism will weaken in FY2010 because of the lagged impact of the global downturn, this will be offset by higher public spending and continued expansion of the financial and the transport and communications subsectors.

Agriculture is expected to expand by 3.0% in FY2009, underpinned by the good summer crop (mainly paddy), but damped by a poor winter crop (mainly wheat and barley) due to drought. Assuming normal weather conditions and smoother transport services from improved fuel supply and political stability, the sector is expected to expand by 4.0% in FY2010.

Industry's performance will likely remain sluggish, as power shortages and labor unrest continue to affect manufacturing. While utilities output will not improve (with the decline in output of major power plants and the delayed commissioning of the Middle Marsyangdi Hydroelectric Project), construction activity is expected to pick up in response to the fall in prices of construction materials. Industry is, therefore, projected to grow by a mere 1.0% in FY2009, but with some concrete steps to improve industrial relations and the overall business environment, it is expected to expand by 2.5% in FY2010.

On the demand side, consumption will stay buoyed by remittances, which are likely to continue rising as a result of new labor agreements with several host countries. However, the slowdown in the outward flow of migrant works and the increasing repatriation of some workers from certain host countries in recent months suggest that remittance inflows will likely slow, especially in FY2010.

Owing to high prices of some food items, and of fuel and transport, year-on-year inflation in mid-January 2009 remained high at 14.4%. This reflected supply constraints caused particularly by high transport costs (since domestic fuel prices have not yet been adjusted downward commensurately in response to the drop in world oil prices), increases in the minimum wage and civil service salaries, and the deepening power crisis. Domestic oil and transport price adjustments will likely be made, easing supply bottlenecks in FY2010 when average inflation should moderate to about 8%.

The wide trade deficit will persist. Import growth, though slowing, will be driven by a higher oil import bill stemming from more oil-fired power generation, continued remittance-induced consumer spending, and greater outlays on investment goods. Export growth will be sluggish due to weak external demand and long-standing structural weaknesses. Remittances and tourism receipts should continue to grow, albeit more slowly because of the global economic downturn, but they will still offset the trade deficit.

These developments suggest that the current account surplus will likely shrink to about 1.5% of GDP in FY2009 and to 1.0% in 2010. Although significant increases are unlikely, aid flows are expected to maintain the capital and financial accounts in surplus, which will ensure a continued overall balance-of-payments surplus.

3.19.1 Development challenges

Despite significant poverty reduction from 1996 to 2004 (largely due to remittances), poverty is still widespread and inequality is rising. These are key development challenges, especially in light of the increasingly difficult global and domestic economic environments.

In the complex political transition, the potential weakening of the reform and development focus, which is intended to generate employment and boost rural incomes, poses a major risk to sustaining the poverty reduction gains of the past decade. The drop in remittance inflows and any reduction in aid flows may also undermine these gains.

Generating widespread domestic employment opportunities has become crucial, especially with a burgeoning labor force and repatriation of migrant workers. Improving the business and investment environment will be important to achieve strong employment growth. To this end, various bottlenecks need to be tackled, particularly growing management–labor tensions, lack of skilled labor, inadequate (especially power-related) infrastructure, and limited access to rural finance.

The entry of a large number of financial institutions in the past couple of years poses a major challenge for the central bank with its limited institutional capacity to effectively supervise and regulate them. However, losses due to the international financial crisis do not affect local banks and the housing market is expected to remain stable.

Pakistan

A sharp deterioration in current account and fiscal balances in 2008, amid escalating inflation, led to a depletion of foreign exchange reserves. This, in turn, triggered a balance-of-payments crisis. The immediate threat to economic stability and the servicing of international debt obligations was overcome through a stabilization program backed by the International Monetary Fund. The growth model of recent years has several structural weaknesses, which result in recurring boom-bust cycles and overdependence on foreign capital. Beyond the immediate fiscal and monetary steps, the country needs a long term strategy and action plan to transform, upgrade, and diversify the economy, in particular manufacturing. The objective is to generate employment, and relax the balance-of-payments constraint to growth.

Economic performance

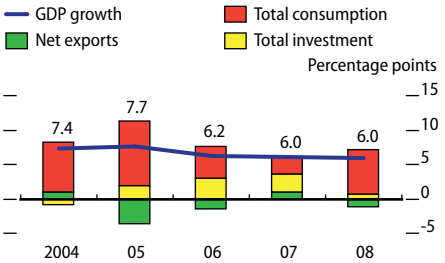
During FY2008 (ended 30 June 2008), the economic situation deteriorated significantly after 5 years of respectable growth that averaged around 7%. The growth during FY2003–FY2007 was premised on economic reforms and an expansionary policy framework that aimed to achieve high growth rates. This framework banked on the (at the time) substantial available external capital inflows. These inflows also helped build up foreign exchange reserves.

Aggravated by unprecedented oil and food price shocks in FY2008, though, the economy started having problems attracting inflows, and its economic fundamentals worsened. The resulting steep drawdown of reserves led policy makers to turn to the International Monetary Fund (IMF) for support for its stabilization program, in November 2008. The program, based on tightened fiscal and monetary policies, aims bring down the current account deficit, shore up reserves, and cut inflation, but will have a depressing impact on growth in the short to medium term.

Growth dropped to 5.8% in FY2008. Significant factors constraining growth have been the sharp decline in the growth of private investment resulting from political uncertainty, the worsening security situation, and the impact of high international oil prices and frequent power shortages. The contribution of investment to growth fell to only 0.7 percentage points in FY2008 compared to 2.7 percentage points in the preceding fiscal year (Figure 3.20.1). Yet the saving–investment gap (private sector deficit) widened, as a result of a decline in the saving-to-GDP ratio. The contribution of net exports to growth turned negative caused by the oil price hike and a continued slowdown in textile exports. Without the robust consumption growth in FY2008, GDP growth would have been even lower.

On the supply side, growth in agriculture and industry (Figure 3.20.2)

3.20.1 Contributions to growth (demand)



Source: Ministry of Finance, *Pakistan Economic Survey 2007–08*.

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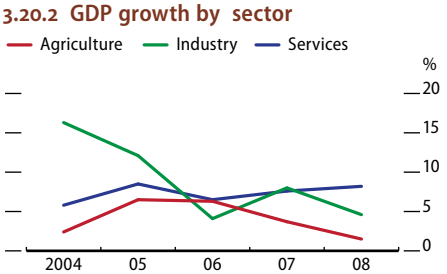
3.20.2 GDP growth by sector



Source: Ministry of Finance, *Pakistan Economic Survey 2007–08*.

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This chapter was written by Jesus Felipe of the Central and West Asia Department, ADB, Manila; and Safdar Parvez of the Pakistan Resident Mission, ADB, Islamabad.

was less than half the respective targets for FY2008. Water scarcity and the high price of fertilizers brought down growth of major crops. Industrial growth remained subdued. Therefore, most of the supply-side expansion came from services.

The oil price shock and the high wheat import price, when combined with the failure to adjust domestic prices in line with international price movements, led to a massive buildup of unbudgeted subsidies and resulted in a high fiscal deficit of 7.4% of GDP in FY2008—the highest in 9 years. Also, block payments on maturing government certificates issued in the 1990s steeply increased debt service and contributed to the larger deficit (Figure 3.20.3). In the absence of foreign inflows, the deficit had to be financed mainly through domestic borrowings from the central bank. Development expenditure planned in the budget had to be cut to accommodate the untargeted subsidies. The tax-to-GDP ratio remained at a low 10%.

Subsidies on oil, food, fertilizer, and power contributed to the budget deficit but failed to contain inflation as food prices soared and the price of fuel was adjusted upward in the last 4 months of FY2008. The steep depreciation of the Pakistan rupee stoked inflation pressures. The consumer price index on a year-on-year basis climbed to 21.5% in June 2008 and to 25.3% in August—the highest in 30 years. Core inflation also increased (Figure 3.20.4). As food prices rose sharply (to 32% in June 2008 year on year), the poorest groups in society were the hardest hit.

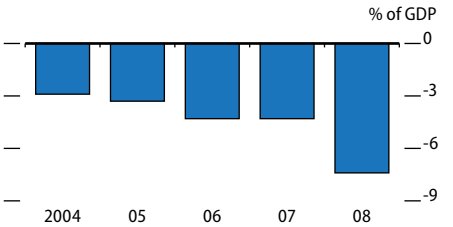
With declining international commodity prices and a slowing domestic economy, the year-on-year consumer price index fell to 20.5% and food inflation to 21.6% in January 2009. Domestic inflation would have fallen by more had the Pakistan rupee not depreciated by 15.9% against the United States dollar in the first 7 months of FY2009.

Reacting to rising inflation and the sharp increase in imports, the State Bank of Pakistan, the central bank, tightened monetary policy three times in FY2008 with a cumulative increase of 250 basis points in the discount rate (Figure 3.20.5). The interest rate climbed by another 300 basis points to 15% (the highest in South Asia) by November 2008 under the IMF program as inflation persisted, the drain on the reserves continued, and the Government sought to reduce its borrowings from the central bank by making Treasury bills more attractive to commercial banks.

This tightened monetary stance was opposite to that adopted in much of the developed world, which was grappling with a worsening global economic downturn. The rise in interest rates did not subdue inflation however, since it is largely driven by supply, not demand.

However, as banks started to face a liquidity crunch caused by a major drawdown of their net foreign assets, the central bank was forced to relax monetary policy during September and October 2008 through open-market operations and reductions in the cash-reserve and statutory liquidity requirements. These measures coincided with the above increase in the discount rate, thus implementing potentially inconsistent measures. The central bank maintained unchanged its monetary tightening policy as it was able to drain the excess liquidity thorough open-market operations in December 2008.

3.20.3 Fiscal deficit



Source: Ministry of Finance, *Pakistan Economic Survey 2007–08*.

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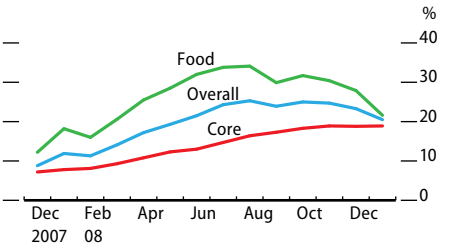
3.20.4 Inflation



Source: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 16 March 2009.

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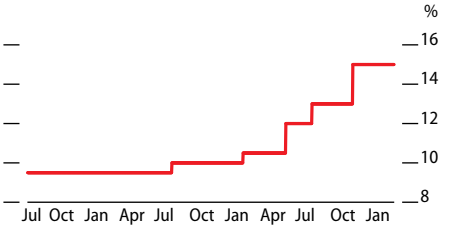
3.20.5 Policy rate



Source: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 16 March 2009.

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The central bank's liquidity management lent stability to the Karachi Interbank Offered Rate. The real lending and deposit rates, as a result, remained negative even after the increase in the policy discount rate in November 2008. The declining trend in the real rate failed, however, to help the private sector credit uptake, which plummeted by 48% during 1 July 2008–16 February 2009 relative to the corresponding period in the previous fiscal year. Weak external demand and deceleration in imports affected the appetite for credit from the demand side and a risk-averse stance of banks with their rising level of nonperforming loans squeezed the availability of credit from the supply side.

The current account deficit widened to $14.0 billion (8.4% of GDP) in FY2008 (Figure 3.20.6), from $6.9 billion (4.8%) in FY2007, as the trade balance recorded its highest-ever deficit of $15.3 billion. Imports expanded almost twice as fast as exports. The oil import bill jumped by 43% and food imports by 46% in FY2008 relative to FY2007. In exports, while rice and cement showed strong growth, textiles remained stagnant. The income and services accounts also recorded larger deficits than in the preceding fiscal year. The current account deficit would have been larger in the absence of a robust 17% growth in workers' remittances.

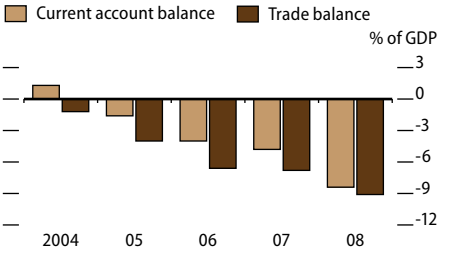
Managing the fiscal and current account deficits became a key challenge for the Government. The financial account surplus declined by $2.5 billion in FY2008 as external and domestic economic shocks led to a massive adjustment in portfolio investment, which declined to just $41 million from $3.3 billion in the prior year. Foreign direct investment in FY2008 showed no change, at $5.1 billion. The Government's privatization program stalled. Multilateral disbursements, however, recorded a 14% increase in FY2008.

With the large current account deficit and the deterioration in the financial account, the rise in interest rates in FY2008, besides being unable to stem inflation, was insufficient to arrest the depreciation of the Pakistan rupee and to stop the depletion of foreign reserves. The nominal exchange rate sank by 11.3% and the real effective exchange rate depreciated by 2.3% despite high domestic inflation (Figure 3.20.7). Foreign exchange reserves dropped by almost one third, to end FY2008 at $11.0 billion (Figure 3.20.8).

Following the slowdown in non-debt-creating inflows, the financing burden of the fiscal and current accounts led to a large accumulation of debt, both domestic and foreign. The debt-to-GDP ratio increased for the first time in 3 years to 58.8% (Figure 3.20.9). This went counter to the Fiscal Responsibility and Debt Limitation Law of 2005, which requires a 2.5% annual reduction in that ratio. Debt as a share of public revenue also increased and the share of short-term floating debt rose as the Government's borrowings from the central bank rose.

The ratio of external debt to GDP, however, declined moderately (by 0.6 percentage points), although the absolute level of external debt rose by $5.46 billion with an increase in multilateral borrowings. The depreciation of the Pakistan rupee also caused the local currency–denominated value of external debt to increase. At the same time, the adequacy of reserves to back foreign debt diminished.

3.20.6 Current account indicators



Source: State Bank of Pakistan, *Annual Report 2007/08*.

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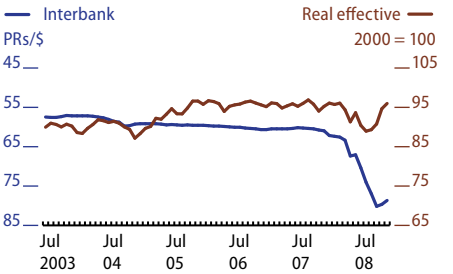
3.20.7 Exchange rates



Sources: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 16 March 2009; International Monetary Fund, *International Financial Statistics* online database, downloaded 16 March 2009.

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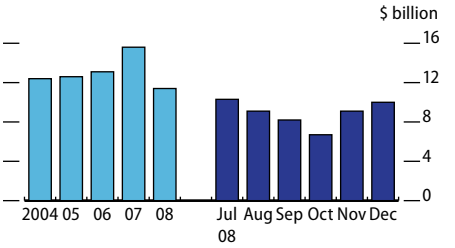
3.20.8 Total foreign exchange reserves



Source: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 16 March 2009.

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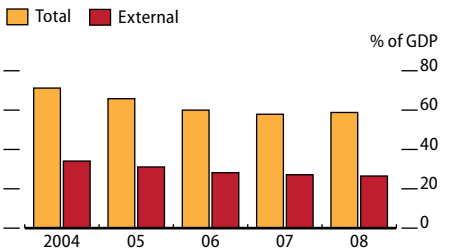
3.20.9 Debt indicators



Source: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 16 March 2009.

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Economic prospects

To stop the steep deterioration in macroeconomic fundamentals in FY2008, the Government prepared a plan to stabilize the economy. IMF endorsed the plan under a standby arrangement (Box 3.20.1).

The measures agreed with IMF aim at stabilizing the economy. In the short run, they will depress the investment and unemployment outlook, and increase the vulnerability of the poor if social assistance fails to reach the targeted groups. While failure to reduce imbalances may hurt future growth, the stabilization policies will hit growth and will lower the potential of the economy. Indeed, as the experience of the Asian crisis of 1997–98 shows, stabilization policy cannot be separated from growth policy. Growth in the Asian crisis–affected countries is significantly lower than during the precrisis period. Moreover, an important lesson of that crisis is that cutting core development spending, such as for infrastructure, during a crisis can have significant long-run costs, as rehabilitation later will be costly and hold back economic recovery.

Fiscal discipline will lead to low inflation, but it will also become a deflationary force, since it creates excess capacity and unemployment. This is an important issue because the ultimate goals have to be job creation and wage and price stability. A key question, therefore, is that in addition to reducing imbalances, the Government needs to implement other policy actions to revive the economy in the medium and long term. These are discussed in the final section on development challenges (Box 3.20.2).

These considerations are relevant because growth in FY2009 is estimated to slow to 2.8% due to the impact of the global slowdown, tight demand management policies, and the power deficit (Figure 3.20.10). Growth in agriculture will improve with respect to that in the last fiscal year, but will remain moderate on account of high input costs (including electricity, fertilizers, and pesticides) and pest attacks. The sugarcane crop has been disappointing, and the cotton crop has been short of target. However, the wheat crop is projected to be very good on account of improved water availability and a 52% increase in the support price for farmers, announced in September 2008.

Energy shortages, the law and order situation, and capacity and input constraints caused by higher import prices from the large depreciation of the Pakistan rupee, will lower industrial performance. Large-scale manufacturing shrank by 5.6% in the first 5 months of FY2009 as textiles, automobiles, metals, food and beverages, and petroleum products all registered declines. Growth in services, too, in FY2009 will moderate as a result of the knock-on effect of the lower growth momentum in the commodity-producing sectors on wholesale and retail trade, as well as of the ongoing consolidation in the telecommunications subsector. The performance of the financial subsector could be affected by the increase in nonperforming loans this year.

GDP growth is expected to improve to 4.0% in FY2010. The expansion will come from greater stability in economic fundamentals, improved financial inflows resulting from gradual easing of global credit conditions that will help revive investment, and the expected improvement in electricity availability as the Government rationalizes the tariff structure

3.20.1 The stabilization program

In November 2008, the Government and the International Monetary Fund reached an agreement according to which a 23-month standby arrangement amounting to $7.6 billion was made available to Pakistan to support its economic stabilization program. The arrangement released $3.1 billion immediately; subsequently quarterly reviews will determine the availability of the remaining tranches.

The two key objectives of the support are: to restore macroeconomic stability and confidence through a tightening of macroeconomic policies; and to ensure social stability and adequate support for the poor and vulnerable in Pakistan.

The specific areas that are being targeted to meet these key objectives are:

- External balance—to be targeted via fiscal tightening.
- Fiscal balance—the program requires a fiscal deficit tightening from 7.4% of GDP in FY2008 to 4.2% in FY2009 and then 3.3% in FY2010. The tightening will come principally through phasing out energy subsidies, better prioritizing development spending, and implementing strong tax policy and administration measures.
- Monetary tightening—through increases in the policy discount rate, to contain inflation, offload government borrowing from the central bank, and build reserves.
- Financial institution reform—structural changes to deal with risk contingencies, insolvent banks and to strengthen the SBP's resolution capacity.
- Foreign exchange intervention by the central bank—geared only toward achieving the program's reserve targets and smoothing excessive exchange rate volatility.
- Social assistance—to be strengthened but better targeted, such that spending on the social safety net will be increased to 0.9% of GDP in FY2009, an increase of 0.6 percentage points of GDP.

and moves to eliminate the intercorporate circular debt problem in the energy sector to reduce the fiscal constraints that now limit production.

The fiscal deficit is expected to decline in FY2009, as the Government removes or reduces subsidies, and rationalizes development expenditure. With the fiscal deficit targeted to fall to 4.3% of GDP, the Government has already fully eliminated the subsidy on petroleum products, and is undertaking a phased reduction in the electricity subsidy, with the target to remove this subsidy too by the end of FY2009. A reprioritization of projects is expected to lead to a slashing of the development budget by over PRs100 billion for FY2009. The fiscal deficit in the first half of the fiscal year of 1.9% of GDP suggests that the authorities are on course on meeting the fiscal deficit target for the full year.

The deficit has been reined in despite a shortfall in tax revenue collected by the Federal Board of Revenue. But this is being offset to a large extent by petroleum development levy receipts because the domestic oil price has not been adjusted downward by as much as the fall in the international price. The Board's tax collection target has been accordingly reduced for the full year. In the event that the revised target also cannot be met, for example, because of the slowdown in economic activity and declining inflation, then further expenditure cutting, mainly on development, might be the only way to meet the fiscal deficit target.

In FY2010, the fiscal deficit is projected to go down further to 3.4% of GDP as ongoing tax administration and policy reforms start to make themselves felt in greater generation of revenue and as expenditure is streamlined. Although fiscal deficits are programmed and although they are projected to decline as a share of GDP, deficits complement private spending and generate adequate and sustainable economic growth by providing the income and growing net financial wealth that meets the private and external sectors' demand at full employment. The fiscal stance plays a very important role in providing "balance" to the economy; it fills the demand gap that is opened up when the operations of the nongovernment sectors (domestic plus rest of the world) are deficient. The economy needs to develop infrastructure and invest in health and education. Deficit spending can be carried out judiciously, and it need not be inflationary because the economy is very far from full employment.

Although global food and oil prices are on the decline, the increase in the wheat support price and the reduction in subsidies, along with currency depreciation, will together keep up the inflationary pressure in FY2009, resulting in an average consumer price inflation of around 20.0%. Despite the fact that inflation pressure declined from November 2008 to January 2009, the consumer price index, food inflation, and core inflation, were still all over 20% on a year-on-year basis. As global commodity prices fall to stabilize at a lower level, and as the base effect of FY2009 manifests itself, inflation is projected to fall to an average of 6.0% in FY2010.

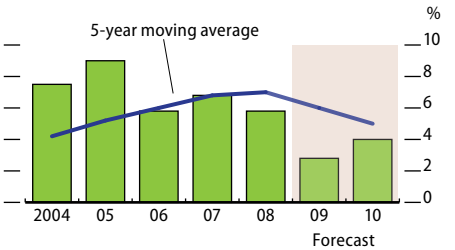
Despite growth in exports, the current account deficit jumped to $7.3 billion during the first half of FY2009, and came in at 20% higher than in the same period in the previous fiscal year. However, the petroleum bill, having doubled in the first 4 months of the fiscal year, then started to show a contraction as the impact of lower international oil prices was felt. Consequently, even with slowing exports, the

3.21.1 Selected economic indicators (%)

	2009	2010
GDP growth	2.8	4.0
Inflation	20.0	6.0
Current account balance (share of GDP)	-6.0	-4.5

Source: Staff estimates.

3.20.10 GDP growth



Sources: Ministry of Finance, *Pakistan Economic Survey 2007–08*; staff estimates.

Click here for figure data

3.20.2 Development challenges

Medium- and long-term prospects depend on the evolution of a model of sustainable growth, in the sense that growth is not confronted with a balance-of-payments constraint every time it attempts to move above 5%. To accomplish this, the economy must develop a growth model of the kind that transformed East Asia over three decades. This must be the objective for the next two decades.

Five interrelated challenges need to be overcome to meet this objective. First, the deterioration in macroeconomic conditions has to be stopped and reversed. Over the past few years, the economy has achieved high growth rates but has remained overly dependent on volatile external inflows. The Government must now focus on increasing the productive capacity of the economy and on generating exports with a higher world income elasticity of demand. Developing countries like Pakistan have to build a robust virtuous circle between increased productive investment and exports.

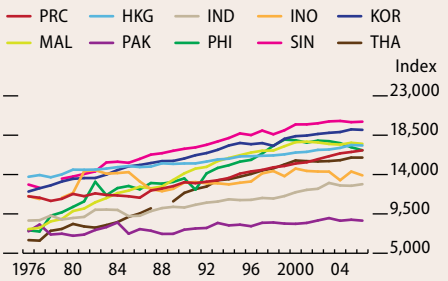
Second, to progress toward a model of sustainable growth, the authorities have to address structural challenges. Although services are the largest sector, the economy is, to all intents and purposes, agrarian. However, agricultural output growth is low and the reallocation of labor from agriculture into industry and services contributes little to overall labor productivity growth. More than 40% of the labor force is employed in agriculture and at very low wages. Development will occur only when agriculture becomes more efficient and when industry and services can absorb the huge surplus of agricultural labor by offering productive and decent jobs.

Moreover, manufacturing, which is concentrated in textiles, shows little sign of quality-upgrading and diversifying. Box figure 1 graphs an index of the sophistication of exports for a selected group of Asian countries. The index reflects the degree to which a country's export basket is similar to that of industrial countries, and shows that Pakistan ranks at the bottom. The reason that this has happened is that the country specializes in the production and export of products at the lower end of the textile range. These are unsophisticated goods with low elasticity of demand, and it is this that underlies the recurrent balance-of-payments problems.

The third challenge is the infrastructure deficit, and in particular the power crisis and prolonged hours of daily load-shedding that choke growth, investment, and private sector development. The Government's efforts to improve governance and financing in the electricity industry through unbundling power entities and privatization, along with tariff reforms and measures to address the circular debt issue, will improve the situation, but only if the reforms are fully implemented. Also needed are new generation capacity and systemic improvements in transmission and distribution systems, immediately and in the coming years. Interventions in these areas have, in fact, begun with the support of development partners.

The fourth challenge is social and relates to the country's poor human development indicators,

1 Export sophistication



PRC = People's Rep. of China; HKG = Hong Kong, China; IND = India; INO = Indonesia; KOR = Rep. of Korea; MAL = Malaysia; PAK = Pakistan; PHI = Philippines; SIN = Singapore; THA = Thailand.

Note: The index was constructed using GDP per capita in constant 2005 international dollars.

Source: Staff estimates.

Click here for figure data

deterioration in the current account deficit was contained—a comparison of the first 7 months reveals that the current account deficit in FY2009 was only 1.5% above the level in FY2008. At the same time, with the release of the first tranche of IMF's standby assistance, foreign reserves went up to $6,477 million in November 2008, having fallen to $4,064 million the previous month. The exchange rate has subsequently stabilized, at about PRs79/$1.

Imports would need to continue to compress significantly in the second half of FY2009 to improve the current account balance, especially as exports will be hit harder by recession in the main importing economies. On these assumptions, the current account deficit is projected to go down to 6.0% of GDP in FY2009. Workers' remittances

3.20.2 Development challenges *(continued)*

particularly in health and education. The Millennium Development Goals will not be achieved unless the pace of progress in this sphere is accelerated significantly.

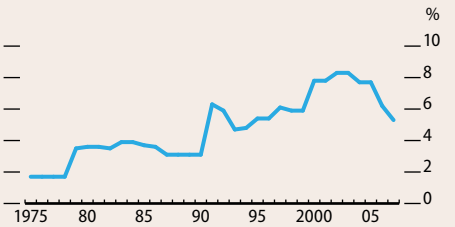
These four challenges contribute to and result in the overarching challenge of high and persistent poverty, unemployment, and underemployment. Having declined to 22.3% in FY2006, poverty has likely risen once again following the slowdown in growth, dismantling of subsidies, and the sharp buildup of inflation in FY2008. Unemployment (Box figure 2) decreased in the preceding years of higher growth but the quality of employment worsened, as there was an increase in the share in total employment of unpaid family workers; today this group represents more than a quarter of all those employed.

The lack of access to productive and decent employment for large segments of the population remains the main cause of poverty. The low level of structural transformation is adding to the problem. Industry does not create employment and, therefore, workers shift from agriculture into low-productivity services jobs. However, services are not creating enough employment to absorb both those moving from other sectors and new entrants to the labor force.

In view of the five challenges, the country needs a carefully thought out medium-term strategy and action plan for industrialization, as well as upgrading and structural change to sustain economic growth. Such a well-developed industrial strategy, understood as a plan for strategic collaboration between public and private sectors, will be an important tool for change—and this change will not come about otherwise. Industrial strategy is not about "picking winners" (favored sectors) but about public and private sectors jointly identifying new activities where the economy can excel. It is also a process of identifying market failures that impede structural transformation, and of removing constraints. This requires strategic collaboration between public and private sectors, as well as the development of the appropriate institutions for change.

Exports are vital to relaxing the balance-of-payments constraint on growth and must be at the center of this development strategy. While textiles and clothing will remain a vital export sector, they cannot be the engine of growth and have to outgrow their current state of low sophistication. Diversification needs to be given the highest priority. A strategy that significantly diversifies and upgrades exports is the only way for Pakistan to achieve sustained high growth and create productive and decent employment.

2 Unemployment



Source: Asian Development Bank, Statistical Database System, downloaded 17 March 2009.

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would need to be sustained to achieve the projected reduction in the current account imbalance—remittances have held up in the first 7 months of the fiscal year. In FY2010, the current account deficit will fall to 4.5% as the trade account improves with stability in oil prices and as export volumes become stronger, reflecting an improvement in meeting demand for electricity.

The current account gap remains a major challenge that was exacerbated by the deterioration in the financial account in the 7 months of FY2009. IMF will provide much-needed balance-of-payments support over the next 2 years but such support cannot indefinitely sustain a large external imbalance. This imbalance imposes a balance-of-payments constraint to sustainable growth in Pakistan: ADB staff estimates indicate that whenever GDP growth exceeds 5% for a number of years—such as the current episode—the country tends to fall prey to a balance-of-payments crisis. This is triggered by imports rising much faster than exports, because Pakistan's exports have a low world income elasticity of demand.

Sri Lanka

Bolstered by agriculture, the economy maintained healthy growth in 2008, though high global food and oil prices boosted inflation and widened the trade deficit. Growth will slow on depressed export demand in 2009, with the worst effects of the global downturn felt in the balance of payments, creating pressures on reserves and the exchange rate. Meeting fiscal targets for 2009 will be a challenge due to tight financial markets and a fiscal stimulus package. With major military operations expected to end in early 2009, rehabilitation and reconstruction in the north might start this year.

Economic performance

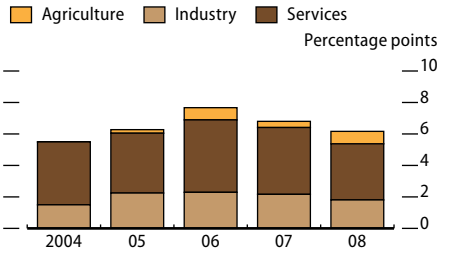
Performance in 2008 was resilient to adverse global financial and economic developments and the intensified civil conflict in the north of the country. As recession battered the United States (US) and European economies, production of export industries slowed somewhat, but overall growth slid only a little, to 6.0% from 6.8% in 2007 (Figure 3.21.1).

Agriculture recorded strong growth of 7.5%; services and industry, moderate growth. Although the Government already had a policy of maximizing agricultural production and minimizing food imports, the shortage of rice early 2008, together with sharp increases in global food prices, spurred its efforts. It launched a major drive to cultivate abandoned paddy lands, which lifted paddy production by half. Tea production was 4% higher than the previous year, though the sector underwent significant price reductions from the third quarter of the year, with the December average price dropping by 36% relative to December 2007 at Colombo auctions.

In services, at over 20% expansion the communications subsector continued to drive sector growth, of 5.6% (down from 7.1% a year earlier). Tourist arrivals and earnings from tourism both fell by 11% year on year, resulting in contraction in the hotel subsector for the fourth consecutive year. Transport and banking services turned in slower growth than in the previous 2 years. Global conditions affected clothing, which slowed to around 2% annual growth and was the main factor reducing industrial growth to 5.9% from 7.6% a year earlier.

Annual average inflation in 2008 was high at 22.6%, well above the prior-year's 15.8%. Year-on-year inflation peaked in June at 28.2%, and stepped down gradually to 14.4% by December (Figure 3.21.2). In fact, the economy had experienced a persistent rise in inflation since 2006, a phenomenon linked primarily to bank-financed government deficits. However, June's spike stemmed from higher fuel and food prices, originating in the lifting of subsidies on fuel in 2006 and on electricity in 2008, which allowed global oil prices to be fully reflected in price developments.

3.21.1 Contributions to growth (supply)



Source: Central Bank of Sri Lanka, available: http://www.cbsl.gov.lk, downloaded 9 March 2009.

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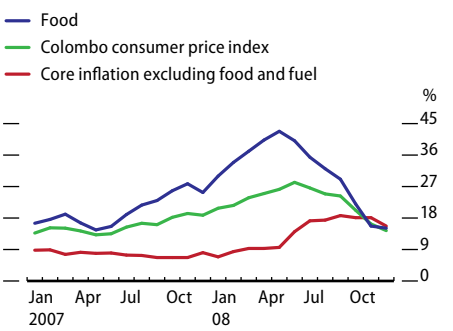
3.21.2 Inflation



Source: Department of Census and Statistics of Sri Lanka, available: http://www.statistics.gov.lk, downloaded 20 February 2009.

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This chapter was written by Narhari Rao and Nimali Hasitha Wickremasinghe of the Sri Lanka Resident Mission, ADB, Colombo.

To help deal with escalating oil prices, the Ceylon Petroleum Corporation had made hedging agreements with commercial banks from 2006, but with tumbling oil prices in the second half of 2008 it incurred heavy losses. An order by the Supreme Court, which had earlier suspended the agreements on account of wrong procedure, was removed in January 2009, compelling the Corporation to honor its payments to the banks. It is unclear whether these payments will be made, as the central bank has since issued a directive to stop the payments.

The central bank tightened its monetary policy in 2008. It lowered its reserve money growth targets on three occasions during the year from 14.7% to 9.7%, in a bid to restrain rising inflation pressures. As a result of tight liquidity and the resulting high interest rates, growth in credit to the private sector decelerated to around 9% toward the end of the year from the 20–26% seen in 2007 (Figure 3.21.3). Real interest rates were negative for most of the year, becoming positive only in the last 2 months, as inflation dropped below 20%.

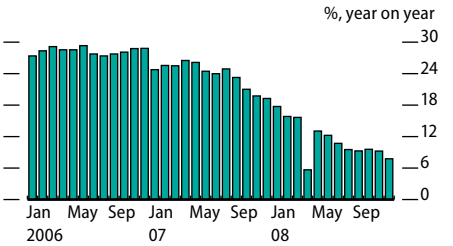
Late 2008 saw a liquidity shortfall in the market precipitated by the global financial crisis, which caused an outflow of dollars from the system. The central bank reduced the statutory reserve requirement of commercial banks by 225 basis points in two steps in 2008 to inject liquidity into the market. It further reduced this requirement by 75 basis points in February 2009, releasing SLRs9 billion into the system. The central bank has also been injecting additional liquidity by providing repo facilities to commercial banks and primary dealers.

The high global food and fuel prices prompted the Government to take certain fiscal measures that resulted in revenue losses in 2008. These steps included reducing import tariffs on food and cutting value-added tax on gasoline from 15% to 5%. However in May 2008, it removed an import duty waiver that had been in effect on gasoline imports to cross-subsidize the price of diesel, and imposed a duty of SLRs20 per liter. The Government has resorted to ad hoc cesses to raise additional revenue, and cess revenue now accounts for 4.3% of the total tax take, up from 1.4% in 2006. This development has made the tax system increasingly complex, and the 2009 budget called for a presidential task force to plan a rationalization.

Revenue and capital expenditure continued to underperform relative to budgeted levels. Although the deficit continued its narrowing trend of 2006 and 2007, it stayed high at nearly 7% of GDP in 2008 (Figure 3.21.4). On the expenditure side, fertilizer subsidies exerted heavy pressure on the budget, because of the increase in international prices in the first half. Full-year expenditure was driven mainly by these subsidies and defense, at the expense of the ambitious public investment program, which, due to a shortage of counterpart funds, is estimated to have spent 17% less than the budgeted amount

The 2009 budget was presented in a deteriorating global scenario, which poses specific challenges to the Sri Lankan economy in terms of raising funds in the international market, risks to exports, falling reserves, and pressure on the rupee. This year the Government was also facing difficulties in meeting counterpart funding commitments. However, while some support was provided to foreign exchange–earning industries (such as tea, garments, hotels, and rubber), there are no specific

3.21.3 Private credit growth



Source: CEIC Data Company, Ltd., downloaded 11 March 2009.

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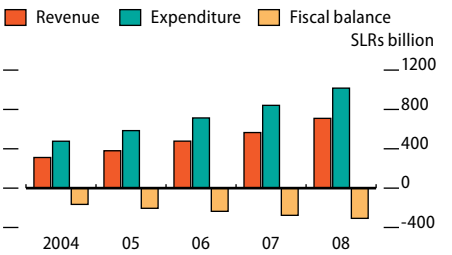
3.21.4 Fiscal indicators



Source: Central Bank of Sri Lanka, available: http://www.cbsl.gov.lk, downloaded 20 February 2009.

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measures in the budget proposals to address these challenges. After debt repayments and interest payments, defense makes up the largest single cost category, accounting for 10% of total expenditure.

In the revenue proposals, income tax brackets have been expanded resulting in lower tax payments for all levels of income. Value-added tax has been brought down from 15% to 12%. Cesses have been imposed and rates increased on items already covered, to encourage domestic industries. The budget deficit is expected to come down to 6.5% in 2009, from an estimated 7% of GDP in 2008.

The Government's total external foreign currency commercial debt declined from $485 million at end-2007 to $460 million a year later. The authorities have been increasingly turning to foreign commercial borrowing in recent years, the share of which, in total foreign debt, rose from 5% in 2003 to 13% in 2007. As the maturities are relatively short, the roll-over risk of this debt is high in the current environment. The central bank had proposed to borrow $300 million in the international capital market in the latter part of 2008, but failed to push through with this because of the prevailing global conditions. For example, the sovereign spread for Sri Lanka rose to about 1,300 basis points in October. The debt-to-GDP ratio, at 85% at end-2007, was down to 78% 12 months later, aided by high nominal GDP growth.

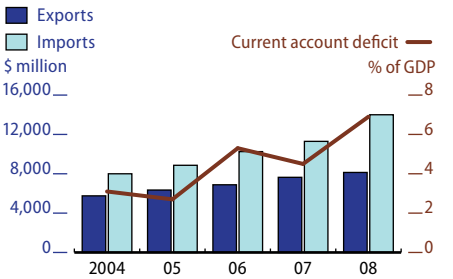
The most direct effect of the global economic turmoil in the current account was on the trade deficit: slowing export demand and high global prices widened it by 61% to $5.9 billion; the import bill rose by 24.0%, mainly on high oil prices. Clothing exports were affected by recession in the main markets and grew by only 5% during the year.

On a positive note, the Generalized System of Preferences, plus concessions available from the European Union, was conditionally extended for 3 more years. This was a relief to a clothing industry already affected by worsening global conditions. Despite healthy growth of remittances (of around 16% to $2.9 billion), the current account deficit is projected at $2.9 billion, or about 7.1% of 2008 GDP (Figure 3.21.5). The capital and financial account was in surplus owing to large inflows, including Sri Lanka Development Bonds of $250 million, a syndicated loan of $150 million, foreign direct investment, and a credit line from the Islamic Republic of Iran for oil.

The central bank has intervened in the foreign exchange market since 2007 to keep the Sri Lanka rupee stable against the US dollar. With the eruption of the global financial crisis, foreign exchange drained from the country, occasioned by a fall in nonresident holdings of Sri Lankan Treasury paper and the settlement of large petroleum bills in the last quarter of 2008. This, with high inflation, exerted depreciation pressure on the local currency (Figure 3.21.6). In response, the central bank intervened, seeking to maintain the rupee at about SLRs107/$1, but this intervention entailed a large drop in official international reserves from $3.4 billion at end-August (Figure 3.21.7) to $1.8 billion at end-December 2008 (equivalent to 3 months and 1.5 months of imports, respectively).

During the fourth quarter, the central bank relaxed its stance somewhat and allowed greater flexibility in exchange rate movements, primarily because of a sharp decline in export prices, lower export demand due to the slowing global economy, and the sharp appreciation

3.21.5 Current account indicators



Sources: Central Bank of Sri Lanka, available: http://www.cbsl.gov.lk, downloaded 9 March 2009; staff estimates.

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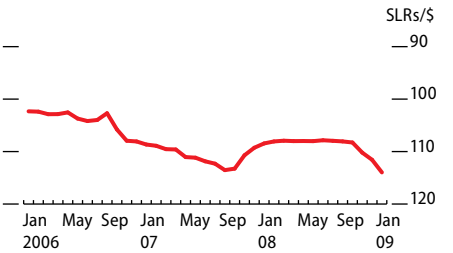
3.21.6 Exchange rate



Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 10 March 2009.

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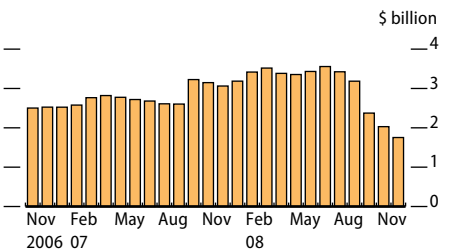
3.21.7 Gross official reserves



Source: Central Bank of Sri Lanka.

Click here for figure data

of the US dollar against most major currencies. To contain imports, the central bank also imposed a 100% margin (deposit) when traders opened letters of credit for selected imports in November. The imports covered under this include electrical items, liquor, confectionery, and household items. This created great difficulties for small and medium-sized importers who generally rely on an advance against imports credit scheme, and find it hard to pay upfront.

Economic prospects

The main concerns for 2009 and 2010 are slowing growth, a deteriorating balance of payments, and meeting fiscal targets. Although the domestic financial system has reported no direct losses from foreign securities, the global financial crisis and economic slowdown mean that Sri Lanka faces tighter access to capital markets and weaker demand for its exports.

Growth is expected to fall to 4.5% this year as the global slowdown deepens, affecting export industries. In addition, last year's exceptional agricultural performance is unlikely to be repeated. On the positive side, there are signs that the civil conflict could end this year, paving the way for reconstruction, which should give a stimulus to the economy if financing is available. Growth is forecast to rebound to 6.0% in 2010, reflecting a measure of global economic recovery (Figure 3.21.8).

Inflation dropped to 7.6% in February 2009, reaching single digit levels for the first time since July 2006. It will continue its downward trend, following global prices lower, and is expected to average 8.0% this year. However, inflation has historically been high and has been affected by government borrowings from the domestic banking sector. Keeping inflation low will therefore depend on the Government's borrowing program as well.

The Government expects to ease the monetary policy stance a little this year, according to the Financial Road Map for 2009 released by the central bank. That document also states that the growth of broad money is targeted at around 14% this year, which is expected to facilitate the Government's projected growth rate of 5–6%. The targets have been set with annual inflation in mind of 9% this year. With inflation falling, the central bank cut its policy rates by 25 basis points in February, the first change in 2 years. Market interest rates can also be expected to fall. Easing of monetary policy is intended to stimulate the economy and help counter the negative impact of the global slowdown.

Since Sri Lanka's financial system was not exposed to the toxic assets of the US and European systems, it should remain largely unscathed. However, nonperforming loans seem to be rising, because industries such as clothing, tea, and construction are facing difficulties. These problems will persist during 2009 when borrowing sources stay limited.

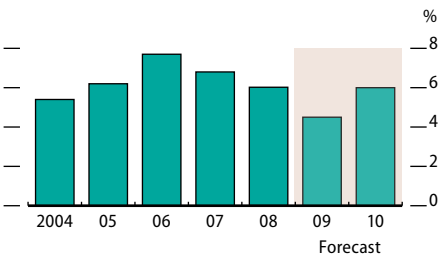
Maintaining fiscal discipline in 2009 will remain a major challenge. The budget for 2009 expects the deficit to fall to 6.5% of GDP, a view underpinned by assumptions of discipline in current spending and strong revenue performance. Historically, both these targets have been hard to meet, leading to cuts in the capital budget to maintain the deficit at a manageable level. The public investment program will also depend on the Government's ability to raise funds in international capital markets,

3.21.1 Selected economic indicators (%)

	2009	2010
GDP growth	4.5	6.0
Inflation	8.0	6.0
Current account balance (share of GDP)	-7.5	-7.0

Source: Staff estimates.

3.21.8 GDP growth



Sources: Central Bank of Sri Lanka, available: http://www.cbsl.gov.lk, downloaded 9 March 2009; staff estimates.

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which will remain problematic this year: Sri Lanka's sovereign rating was downgraded in 2008 both by Fitch (to B+ from BB-) and Standard & Poor's (to B from B+). The rating was further downgraded by Fitch to B in February this year.

With revenue measures focusing on protecting the poor and tax collection increasingly depending on trade-related taxes, the implications for revenue collection may be significant in the current global context. The Government announced a stimulus package of SLRs16 billion with cuts in energy prices and incentives for exporters in 2008. The package includes the removal of a 15% surcharge on electricity for the tourism, garments, leather, and rubber industries, lifting the cess tax on manufactured rubber exports and giving tea producers price support through state purchases.

The sources for funding the package and its implications for the budget deficit are still unclear. The interventions, which the Government sees as necessary to maintain growth, would make it harder to meet fiscal targets in 2009; the fiscal space for such interventions is also limited on account of the high deficit.

In terms of the trade balance, the global downturn's impact on exports will be softened by a lower import bill (largely reflecting lower fuel prices). The current account deficit will remain high at around 7.5% of GDP in 2009, given lower exports and slowing remittances. Exports will fall due to lower external demand and lower prices, which have already affected the tea industry. With exports and GDP growth expected to pick up during the second half of 2010, the current account will start to improve that year.

As international financial markets remain tight, financial inflows will be substantially lower than in 2008. This, coupled with falling reserves, will pose serious risks to the economy. The Sri Lanka rupee is expected to depreciate further in the first half of this year. Given the relatively low foreign exchange reserves, the Government's decision to allow more depreciation in the exchange rate in late 2008 was correct. The overvalued currency is hurting exports, and exporters have been lobbying for a larger depreciation. However, any depreciation of the rupee will increase debt repayments in rupee terms and add to the fiscal burden. Considering all these factors, the Government needs to follow a more active exchange rate policy, which should be supported by greater fiscal restraint to minimize risks and maintain export competitiveness.

The Government announced strategies to boost reserves in January 2009, such as currency swaps with some central banks, promotion of investments in Treasury bills and bonds among the Sri Lankan diaspora, bonus interest on nonresident and resident foreign currency deposits, and a concessional final income tax for new foreign exchange inflows. With markets tight and investors cautious and risk averse, the effectiveness of these measures remains to be seen.

On the positive side, the Government is negotiating with the International Monetary Fund a Standby Facility of $1.9 billion. An agreement would provide support to reserves and have other positive effects such as of improving investor confidence and support for the exchange rate.

3.21.1 Development challenges

The contribution of manufacturing to GDP has expanded only marginally since the 1970s. The economy has moved from agriculture to services, but the manufacturing base has remained concentrated on garments, processed food, and chemical and plastic products. Since the opening of the economy in the late 1970s, export processing zones have been set up and wide-ranging incentives offered to attract foreign direct investment for industrial development.

With the 2008 budget, the Government started rationalizing tax exemptions provided to foreign companies, which have been costly in revenue terms. In the 2009 budget, it raised the issue of broadening manufacturing's base. But doing this and attracting investment may be difficult during the global recession, and the success of both will depend on improving the investment climate.

The 2009 budget proposed to set up a presidential task force to prepare a national tax policy. The current tax system is complicated and has been subject to ad hoc changes, and although progress has been achieved over the last few years to broaden the tax base, the changes in the 2009 budget do not support this trend.

It is a positive development that the Government has recognized the importance of simplifying the tax system and has proposed to set up a task force for this. However, such initiatives have fallen far short of expected outcomes in the past on numerous occasions. The challenge is to ensure that the proposed task force will not meet a similar fate.

Southeast Asia

Brunei Darussalam
Cambodia
Indonesia
Lao People's Democratic Republic
Malaysia
Myanmar
Philippines
Singapore
Thailand
Viet Nam

Brunei Darussalam

GDP is estimated to have contracted in 2008 as a result of a decline in oil and gas production, which dominates this economy. Lower external demand for energy and the fall in global energy prices are likely to suppress growth again this year. Hefty surpluses in the fiscal and external current account provide a deep cushion against external shocks. Efforts to diversify the economy have made some advances, but if the private nonenergy sector is to expand more rapidly, progress is required to streamline business regulation, foster innovation, and develop the financial market.

Economic performance

The economy depends heavily on oil and natural gas: production of hydrocarbons, including liquefied natural gas, accounted for about half real GDP in 2007 (Figure 3.22.1). The nonenergy sector comprises mainly services (42% of GDP), of which government services account for a significant share (19% of GDP). Manufacturing and agriculture are small at less than 2% of GDP each. Private sector activity, other than in oil and gas, grew modestly from 28.3% of GDP in 2003 to 31.0% in 2007. This consists predominantly of wholesale and retail trade, transport and communications, finance, construction, real estate, and other services.

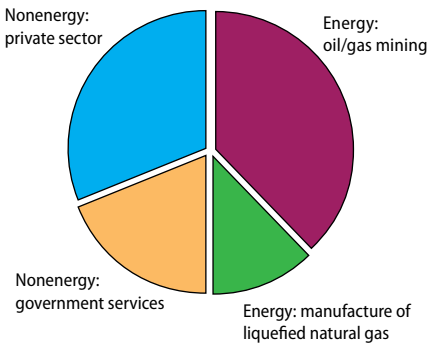
GDP fell by 3.9% in the first half of 2008 (the latest period for which data are available). For the full year, GDP is estimated to have contracted by 2.7% (Figure 3.22.2). Aging oil and gas fields and consequent stoppages in production for maintenance and upgrading of wells and pipelines were the primary reasons for the lower economic output. The Government's desire to extend the life of energy production, in view of limited proven reserves and until a vibrant nonenergy sector develops, also means that the long-term trend of energy output has been broadly stable (Figure 3.22.3).

Government services also likely contributed less to GDP in 2008 than in 2007. A government decision to bring forward bonuses paid to civil servants had the effect of increasing the measured value of government services late in 2007. This effect started to dissipate in the second quarter of 2008.

Large current account surpluses, equivalent to close to 50% of GDP in recent years, are mainly attributable to merchandise trade surpluses. Higher global oil and gas prices lifted export receipts, offsetting the decline in production. Exports of oil and gas were equivalent to more than 96% of total export revenue in the first half of 2008. Major customers in order of importance are Japan, Indonesia, Republic of Korea, and Australia. Clothing shipments, which make up the bulk of other merchandise exports, have declined since the expiry of global quotas at end-2004.

Import values are much lower than those of energy-oriented exports, reflecting the small population (390,000 in 2007) and economy (GDP of

3.22.1 Composition of real GDP, 2007



Sources: Department of Economic Planning and Development, *Brunei Darussalam Statistical Yearbook 2007*; staff estimates.

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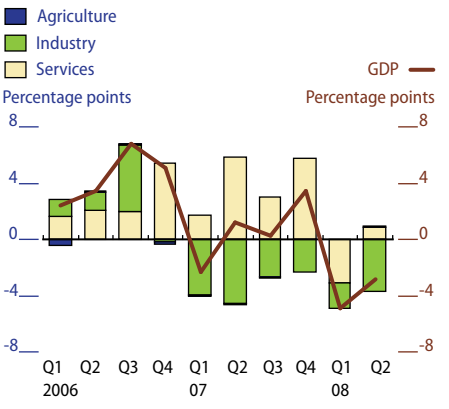
3.22.2 Contributions to growth (supply)



Sources: CEIC Data Company Ltd., downloaded 16 March 2009; staff estimates.

Click here for figure data

This chapter was written by Sharad Bhandari and Mohammed Parvez Imdad of the Southeast Asia Department, ADB, Manila.

US$12.3 billion in 2007). Machinery and equipment have the largest share of imports. Brunei also imports most of its food.

Inflation averaged 2.7% last year, well above the 0.6% average of the previous 5 years (Figure 3.22.4). Food (29% of the consumer price basket) was the primary contributor, reflecting higher international prices.

A currency board arrangement, which links the Brunei dollar to the Singapore dollar one to one, has contained inflation expectations and, historically, contributed to low inflation. The inflation rate in Brunei is also suppressed by an extensive system of government subsidies, covering rice, sugar, and fuel, as well as housing, education, and health services. Prices of motor vehicles, infant milk powder, cigarettes, and cooking oil are controlled. The absence of taxes on personal income and on sales of goods and services also helps keep inflation low. The only significant taxes are levied on corporate profits. Import duties are also low, equivalent to 2.4% of total tax receipts in FY2007 (ended 31 March 2008).

Taxes, dividends, and royalties from oil and gas companies account for about 90% of fiscal revenue (Figure 3.22.5). Fiscal expenditure has fallen in the past couple of years, mainly reflecting a decline in development spending. Implementation of projects under the national development plan, Rancangan Kemajuan Negara 2007–2012 (RKN), has lagged significantly behind allocations. Higher revenue and lower expenditure have contributed to a sharp increase in the fiscal surplus in recent years.

In order to speed up RKN project implementation, the Government last year devolved the appointments of project consultants to each ministry responsible for the projects. It also moved toward a design–build method for projects so that one provider (contractor or designer) is accountable for both the design and construction.

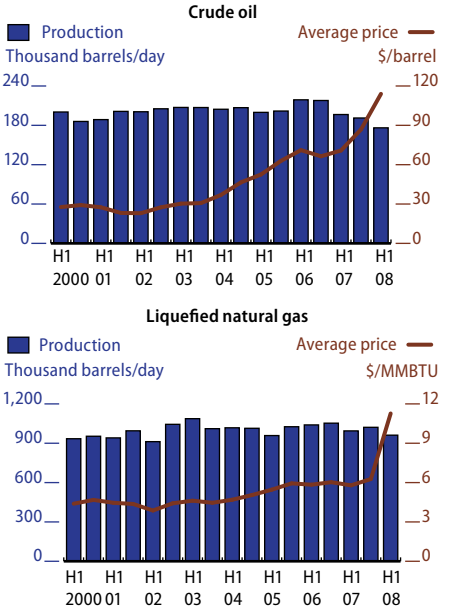
Some advances were made in diversifying the economy in 2008. Construction started on a US$450 million methanol plant and is scheduled to be completed by the end of this year. It is the first major investment at the Sungai Liang Industrial Park, which is being developed as a petrochemical hub. iCenter, the country's first business incubator to develop local small and medium-sized enterprises in information and communications technology, was launched in 2008. About 16 companies have started providing business services in Internet and related applications in the iCenter.

Economic prospects

The global economic downturn is transmitted to Brunei's economy primarily through lower world demand for energy and the fall in international energy prices. The country has ample financial resources of its own and no external debt, so transmission through the financial channel is limited. Income from investment in foreign assets may moderate, but is unlikely to have a significant impact near term given the country's large resources. Foreign direct investment and tourism may slow somewhat, though.

The lack of timely and comprehensive economic data for recent periods makes forecasting difficult. Furthermore, given the unpredictable nature of unplanned stoppages for maintenance that has affected oil and

3.22.3 Hydrocarbon indicators

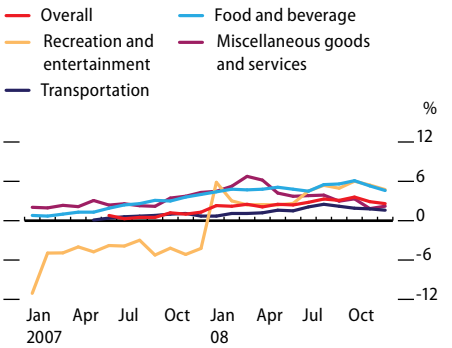


MMBTU = million British thermal units.

Source: Department of Economic Planning and Development, *Brunei Economic Bulletin*, December 2008.

Click here for figure data

3.22.4 Inflation



Source: CEIC Data Company Ltd., downloaded 16 March 2009.

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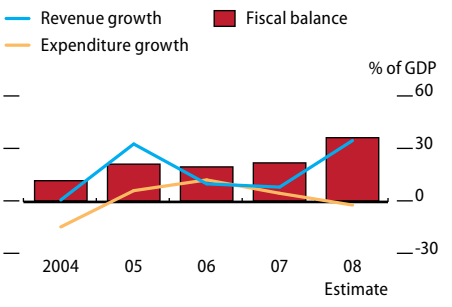
3.22.5 Fiscal indicators



Note: Data are for fiscal years running from April to March.

Sources: Ministry of Finance, Brunei Darussalam; staff estimates.

Click here for figure data

gas output in recent years, growth projections are based on assumptions that energy production will decline by no more than 1% in 2009 and 2010 from levels in 2008, when they fell at a significant rate for a second consecutive year. The nonenergy private sector may contract somewhat this year under the cumulative impact of the global downturn on trade, transport, and tourism.

Public spending will support growth. Government services output is expected to increase with efforts to expedite the RKN projects. The contribution of government services to growth should also rise as the unfavorable base effects (from the advancement of bonuses) have dissipated. Based on these factors, GDP growth may contract by about 0.4% this year (Figure 3.22.6).

In 2010, GDP growth is expected to mirror a modest upturn in global demand and a rise in energy prices, although hydrocarbon output may remain subdued. The start of production from the methanol plant and associated activities, as well as the planned Visit Brunei Year 2010, is likely to provide new sources of growth. Public spending will continue to support expansion.

A surplus, albeit smaller, in the fiscal accounts is likely this year. Financing for plausible increases in spending is available, given the accumulation of large surpluses. In addition to assets of sovereign wealth funds, mainly the Brunei Investment Agency, government deposits in the banking system rose from 18% of GDP in 2002 to 20% in 2007.

Export receipts are set to decline significantly this year owing to lower energy prices. Imports may moderate less as investment in RKN projects and requirements for food prop them up. The trade surplus and hence the current account surplus is likely to shrink significantly. However, at above 30% of GDP the current account surplus will remain the largest among the economies of East and Southeast Asia. In 2010, expected exports of methanol and improved inward tourism should also help support the surplus.

Inflation will likely moderate this year and next toward 1% as a result of quiescent world commodity prices. Looser fiscal and monetary policies may preclude a sharper fall in inflation. Monetary policy eased in line with a shift in October 2008 by the Monetary Authority of Singapore to zero appreciation of the Singapore dollar's nominal effective exchange rate, from a gradual appreciation previously.

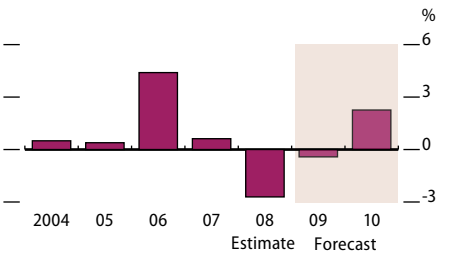
The main domestic risk to the growth forecast is the performance of the oil and gas sector and progress in the RKN projects. If energy output is lower than assumed because of unforeseen problems in wells and pipelines, GDP is likely to contract more than projected. Conversely, smoother energy production would contribute to a possible expansion of GDP this year. The effort to speed up implementation of RKN projects, if successful, could also spur growth.

3.22.1 Selected economic indicators (%)

	2009	2010
GDP growth	-0.4	2.3
Inflation	1.5	1.2
Current account balance (share of GDP)	39.3	35.3

Source: Staff estimates.

3.22.6 GDP growth



Sources: Asian Development Bank, *Key Indicators 2008*; staff estimates.

Click here for figure data

Development challenges

In spite of some success, diversification of the economy away from its dependence on oil and gas remains a major challenge. The country's proved reserves of oil are estimated to be sufficient for close to 20 years and reserves of gas for about 30 years, according to data from the US

Energy Information Agency. Exploration of new fields and expansion of current fields may prolong the life of energy reserves, but heavy reliance on the sector increases the vulnerability of the economy to external shocks.

Various initiatives underpin efforts to diversify. The Government plans to develop Pulau Muara Besar port in Brunei Bay as a container port, export processing zone, and manufacturing hub. In 2008, an international company was appointed as the port operator and another was engaged to develop a master plan. In addition, the authorities have identified several industries for development. These include downstream petrochemicals (in addition to the methanol plant); tourism, acquaculture, and agriculture; Islamic businesses, including halal products and financial services; and information and communications technology services.

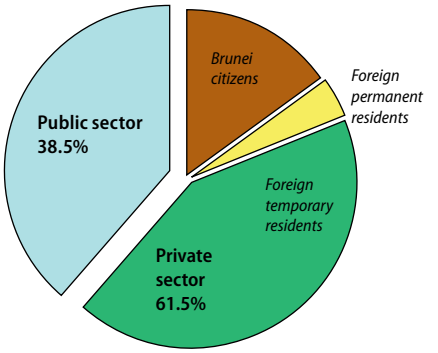
The Government has implemented liberal trade, investment, and labor policies to mitigate the structural constraints that result from a small domestic market and limited human resources. For example, about 75% of private sector employment in 2006 comprised foreign workers (Figure 3.22.7).

Nonetheless, Brunei ranks relatively low for its level of development in the World Economic Forum Global Competitiveness Index (Table 3.22.2) The main constraints, apart from market size, appear to be related to innovation, business sophistication, goods market efficiency, and financial market sophistication. Policies to foster small and medium-sized enterprises by developing incubators, industrial clusters, and training programs attempt to address the first two constraints.

Better alignment of public versus private sector incentives for employees would also be important to attract skilled workers at competitive compensation to the private sector. Recognizing the importance of a robust financial system to foster private sector growth, the Government is developing a plan for a capital market and a modern payment and settlement system.

Detailed indicators of goods market efficiency show a significant competitive disadvantage resulting from the lengthy procedures involved to start a business. The World Economic Forum ranks Brunei 125 on the number of procedures and time required to start a business. The World Bank's *Doing Business 2009* report puts Brunei 88 out of 181 countries in the ease of doing business, compared with 20 for Malaysia and 1 for Singapore. Progress in streamlining procedures for businesses is thus likely to be important in diversifying the economy.

3.22.7 Employment, 2006



Sources: Department of Economic Planning and Development, *Brunei Darussalam Statistical Yearbook 2007*; staff estimates.

Click here for figure data

3.22.2 Rank in Global Competitiveness Index, 2008–09

Details	Rank (in 134 economies)
Overall Index	39
Basic requirements	29
Institutions	41
Infrastructure	39
Macroeconomic stability	2
Health and primary education	47
Efficiency enhancers	77
Higher education and training	69
Goods market efficiency	91
Labor market efficiency	16
Financial market sophistication	75
Technological readiness	54
Market size	116
Innovation and sophistication factors	87
Business sophistication	89
Innovation	91

Source: World Economic Forum. 2008. *The Global Competitiveness Report 2008-2009*, available: http://www.weforum.org.

Cambodia

Headwinds buffeted the economy in 2008, contributing to double-digit inflation and then cutting into economic growth. Continuing weakness in garment exports, tourism, and construction is forecast to reduce GDP growth this year. This deceleration, combined with rising prices, threatens to undermine steady gains made to reduce poverty. Thus the major challenge is to diversify growth and make it more resilient, inclusive, and beneficial to the poor.

Economic performance

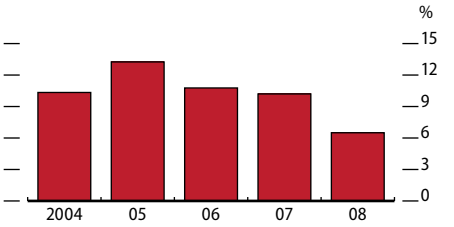
The momentum of high growth in 2007 carried over into the first half of 2008 and slightly beyond, as garment exports and tourism stayed robust, agricultural output relatively strong, and construction activity buoyant. Late in 2008, however, the economy felt the combined effects of political instability in neighboring Thailand and the closure of Bangkok's airports; and of the start of the global economic downturn in terms of an associated deceleration in demand from traditional export markets and weakening investor sentiment. Imports by the principal market, the United States (US), of Cambodian garments declined by 2% in value terms in 2008, according to US data. Tourist arrivals slowed and construction activity fell sharply following a drop in land and property prices after several years of rapid growth.

Largely on the basis of these factors, GDP growth in 2008 slowed to an estimated 6.5% (Figure 3.23.1). Agricultural expansion was relatively buoyant at 4.5%, spurred by good weather and higher farmgate prices, but overall growth in total manufacturing production (5.0%) and services (8.5%) was lower than in 2007.

On the expenditure side, rising domestic demand, fueled by an increase in commercial bank lending and wealth effects from previously fast-rising property prices, stimulated increasing amounts of consumption-related imports and contributed to inflation pressures. Net exports continued to subtract from GDP growth.

Inflation accelerated from 6.4% in September 2007 to a peak of 25.7% in May 2008, driven largely by the global surge in oil and food prices (Figure 3.23.2). In addition, because the economy is heavily dollarized (over 90% of total bank deposits are held in US dollars), a depreciation of the riel and the US dollar against trading partner currencies contributed to imported inflation, while rising domestic demand contributed to domestically generated pressures. The domestic price of rice doubled between mid-2007 and mid-2008, a result of domestic supply shortages, in turn partly created by increased exports from provinces bordering Thailand and Viet Nam in response to higher prices in those countries. Prices of pork, chicken, and fish also rose steeply. Later in the year, food and fuel prices declined and, combined with an appreciating riel and

3.23.1 GDP growth



Sources: Asian Development Outlook database; staff estimates.

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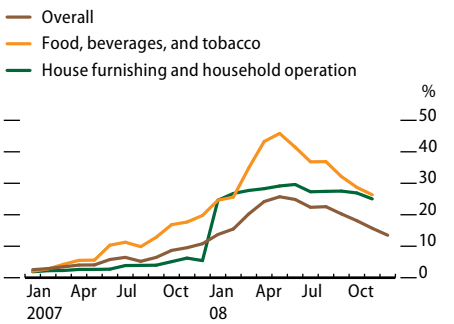
3.23.2 Monthly inflation



Note: Data refer to Phnom Penh only.

Sources: Economist Intelligence Unit, *Country Report*, February 2009; CEIC Data Company, Ltd.; National Bank of Cambodia, available: www.nbc.org.kh, all downloaded 3 March 2009; staff estimates.

Click here for figure data

This chapter was written by Eric Sidgwick of the Cambodia Resident Mission, ADB, Phnom Penh.

US dollar plus monetary policy measures taken at midyear, helped bring down inflation to 13.5% by December. The year-average figure of 19.7% was three times 2007's rate. The riel's real effective exchange rate appreciated by about 10%, reflecting higher inflation in Cambodia.

In response to the higher oil and food prices, the Government took a series of fiscal-related steps to help offset the negative social effects, including raising wages and allowances of civil servants and teachers, and improving the supply of rice in the hardest-hit rural areas. Despite these moves, higher than projected government revenue and containment of current expenditure to its budgeted level permitted an increase in the current budget surplus to 3.7% of GDP.

The overall budget deficit (including capital spending) narrowed to 2.1% of GDP in 2008 from 2.9% the year before. Total domestic revenue rose by just under a half percentage point of GDP, to 12.5%, with tax receipts edging up to 10.4% of GDP (from 10.2% the year before), mainly on continued improvements in administration and collections. Total budget expenditure declined marginally, to 14.6% of GDP, reflecting lower externally financed investment. Concessional loans and grants continued to finance the overall fiscal deficit.

Fueled by rising foreign capital inflows and bank deposits in the first half of the year, broad money growth accelerated sharply, peaking at 63% in April 2008 (year on year) (Figure 3.23.3). This contributed to an unsustainable rate of growth in bank credit, which exceeded 100% (year on year), and stoked inflation. The monetary authorities responded by imposing a 15% limit on bank credit to the real estate sector at end-June, by doubling the minimum reserve requirement on foreign currency bank deposits to 16% a month later, and by easing restrictions on capital outflows.

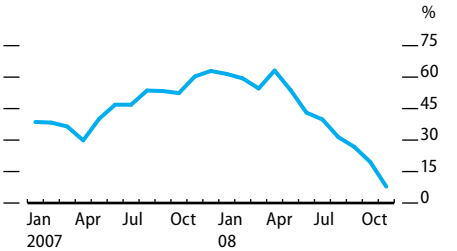
These moves helped ease credit growth and inflation in the second half. After clear signs that inflation pressures were dissipating, on 1 February this year the authorities reduced the minimum-reserve requirement to 12% and removed the cap on lending for real estate.

Export performance is heavily dependent on garment shipments to the US and Europe, but these markets weakened in the second half of 2008. Garment exports were also hurt by higher domestic inflation, which led to a 20% rise in garment workers' minimum wage. In 2008, such exports to the US fell by 2% (Figure 3.23.4), as lower prices more than offset small volume gains.

Rising domestic demand and higher international oil prices lifted imports, and the trade deficit widened to an estimated 18% of GDP in 2008. Growth in tourist arrivals eased to 5.5%, the slowest gain since 2003. Arrivals were up by 10% through midyear, but declined to around 3% following the political turmoil in Thailand and the onset of the global financial crisis. The current account deficit therefore widened to an estimated 14.0% of GDP. International reserves increased to just over $2 billion by December 2008 (equivalent to 3.5 months of import cover), reflecting buoyant inflows of aid and, until the latter part of the year, foreign direct investment (FDI).

Total public debt remains sustainable, but there are risks. At end-September 2008, total nominal external public debt was $2.8 billion, equivalent to 27.0% of GDP (down from 29.7% at end-2007) (Figure 3.23.5),

3.23.3 M2 growth



Sources: CEIC Data Company, Ltd.; National Bank of Cambodia, available: www.nbc.org.kh, both downloaded 3 March 2009.

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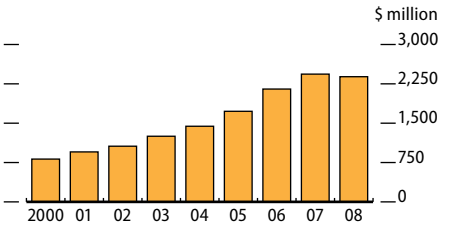
3.23.4 US imports of textiles and clothing from Cambodia



Source: Office of Textiles and Apparel, available: http://otexa.ita.doc.gov, downloaded 3 March 2009.

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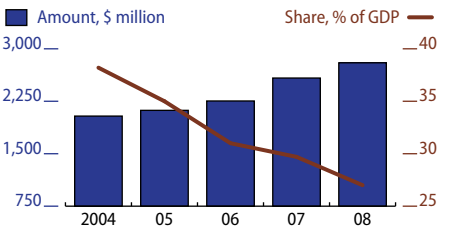
3.23.5 Public external debt



Sources: International Monetary Fund, *Country Report* No. 09/48; staff estimates.

Click here for figure data

while domestic public debt stood at about $100 million, equivalent to 0.75% of GDP, one third in foreign currency. Over half the external public debt stock is owed to multilateral institutions, and includes the negotiated debt stock for the Russian Federation ($457 million) and the agreed amount of total principal owed to the US ($162 million). Most of the external public debt is highly concessional.

The ratio of external public debt service to domestic exports of goods and services is low, at around 0.8%. Cambodia is not servicing its debts with either the Russian Federation or the US and it remains in arrears to both creditors, although negotiations on outstanding debt obligations are continuing. According to an analysis conducted in late 2008, external public debt is sustainable and the risk of debt distress is moderate. However, the country remains vulnerable to external shocks, and a protracted economic downturn could result in debt burden indicators breaching their indicative thresholds for extended periods.

In terms of structural reform, progress was made in implementing a public financial management reform program. Advances were also achieved in preparing for the devolution of functions, human resources, and financial resources from the central to local levels. The aim is to promote transparent and accountable local development and delivery of public services, and to contribute to more effective poverty reduction.

On the logistics front, an automated system for customs clearance and risk management was test-piloted in the port of Sihanoukville (through which 30–40% of total trade is routed), from May 2008. This has reduced processing times and costs for clearing customs, according to private sector users.

As for fostering private sector development, Cambodia moved up a little in the World Bank's *Doing Business 2009* rankings, to 135 in a list of 181 countries, but it fell in Transparency International's *Corruption Perceptions Index 2008*, to 166 out of 180.

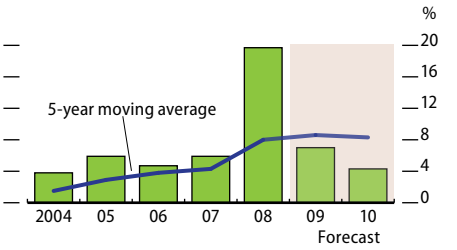
Economic prospects

Inflation, which affects the poor and those on low fixed wages the most, is forecast to decelerate to single-digit levels, but economic growth is set to decline sharply. The following forecasts are predicated on the Government's ability to regain overall macroeconomic stability in the form of a return of inflation to sustained low single-digits (Figure 3.23.6); increased and more efficient infrastructure spending; and a continued safeguarding of the health of the financial system (through sustained improvements in regulation and supervision).

Against this background, growth is forecast to slow to 2.5% in 2009, for three main reasons. First, garment exports are expected to contract because of lower demand in the US and Europe, higher wage costs, cessation of safeguards on the People's Republic of China at end-2008, and increasing competition from Viet Nam. Orders for delivery in the first half of 2009 are sharply lower than at the same time last year, and the outlook is poor for overall retail sales in the US.

Second, the growth in tourist arrivals has already slowed significantly (Figure 3.23.7), reflecting the combination of recession in Europe and a continued decline in the number of tourists from the Republic of Korea

3.23.6 Inflation



Note: Data refer to Phnom Penh only.

Sources: Asian Development Outloook database; staff estimates.

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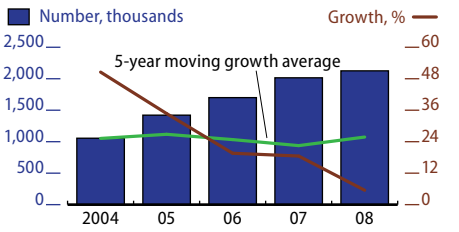
3.23.7 Tourist arrivals



Source: Ministry of Tourism, available: http://www.mot.gov.kh, downloaded 3 March 2009.

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3.23.1 Selected economic indicators (%)

	2009	2010
GDP growth	2.5	4.0
Inflation	7.0	4.3
Current account balance (share of GDP)	-16.0	-10.0

Source: Staff estimates.

(the most important source country), partly owing to a much weaker won against the US dollar.

Third, the recent slowdown in construction growth from rapid rates is expected to continue and to turn negative for the year as a whole, reflecting reduced FDI from Korea, which is heavily invested in the sector, and the decline in property prices. Non-tourism services are also projected to grow much more slowly than in recent years, reflecting the overall downturn in economic activity and sentiment.

On a more positive note, agricultural production is expected to be marginally higher this year than last year's estimated growth of 4.5%, reflecting improvements in irrigation, a drop in fertilizer prices from last year's high, and a continuation of policies to increase production. These policies include improving the availability of high-yield seeds, strengthening disease and pest control, providing more irrigation facilities for dry paddy lands, and increasing the popularity of the system of rice intensification to increase the productivity of irrigated rice cultivation, which has contributed to raising overall land productivity.

Offshore oil and gas deposits have been found, but the amounts that are economically recoverable are uncertain, and any revenues that might be generated from exploiting the deposits would not flow within the forecast period.

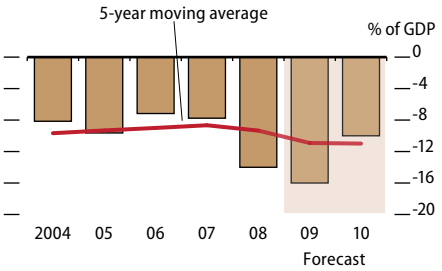
Domestic credit is expected to be somewhat tighter this year, as capital inflows and growth in bank deposits slow. Inflation is forecast to continue moderating, to average 7.0%, reflecting lower domestic demand and global oil prices. The current account deficit is set to widen further, to 16.0% of GDP (Figure 3.23.8), as easing domestic demand fails to compensate for declining export-related receipts from garments and tourism. International reserves are expected to decline, taking import cover to below 3 months.

The Government has requested development partners to accelerate their disbursements on existing projects and their approvals of projects planned for 2009, in order to help offset the likely reduction in private domestic demand and exports. In addition, the prime minister has stated that public spending in 2009 will be redirected toward growth enhancement and social safety nets, although he has not given details. The 2009 budget, which was prepared while the global financial crisis was beginning to unfold, did not contain any specific measures to offset the possible adverse effects of the crisis, but by early March 2009, the authorities had announced their intention to double development spending in 2009 on transport, public infrastructure, and irrigation. They were also considering accommodating a somewhat larger overall budget deficit in 2009 than originally envisaged.

In terms of structural measures, the Government has indicated that it is looking at how to relieve constraints to growth and faster poverty reduction, by, for example, providing some tax relief to the garment and tourism industries, and accelerating trade facilitation reforms.

In 2010, GDP growth is expected to pick up to 4.0%, in line with the anticipated rebound in industrial-country growth in the second half of next year. Inflation is projected to return to its recent historical average of just under 5%, while the current account deficit will narrow slightly to around 10.0% of GDP, as exports recover faster than imports.

3.23.8 Current account



Sources: Asian Development Outloook database; staff estimates.

Click here for figure data

3.23.1 Development challenges

Cambodia recorded strong economic growth averaging over 11% in 2004–2007, which was a key factor in reducing poverty to around 30%. However, this achievement is at risk of being undermined by the sharp run-up in food and fuel prices in 2008, and by the subsequent global financial crisis and economic downturn.

The immediate needs are for the Government to continue bringing down inflation to low single digits, and to help mitigate the adverse effects on the most vulnerable of the decline in growth.

Medium to long term, the Government will need to promote policies and reforms to sustain rapid growth. This requires not only strengthening existing sources of growth, but exploiting new avenues, in particular those that benefit the poor, including—since over 80% of the population lives in rural areas—a renewed emphasis on agricultural and rural development.

Faster rural development could be achieved if the coordination and implementation of various government plans were improved, notably five programs under the Strategy on Agriculture and Water 2006–2010, whose objective is to help diversify economic growth and reduce poverty.

It will also be necessary to integrate these initiatives with related reforms, including the extension of social and physical infrastructure, and the creation of more nonfarm jobs.

Finally, raising the priority for current spending on well-targeted social safety nets for the most vulnerable would also help maintain the gains in poverty reduction.

Indonesia

After expanding by about 6% for several years, growth decelerated in the fourth quarter of 2008 when exports and manufacturing took a hit from the global downturn. GDP growth is forecast to slow this year because of subdued domestic and external demand, before picking up in 2010. Inflation has eased from double-digit rates. Thanks to improved macroeconomic management and a strengthened financial sector, the economy is now in better shape than during the Asian financial crisis. Low levels of public debt, a minimal budget deficit, and its actions to line up external funding support the Government's plans for a fiscal stimulus to bolster the economy.

Economic performance

The economy maintained growth of about 6.3% during the first 3 quarters of 2008, before decelerating to 5.2% year on year in the final quarter as the global slowdown cut into exports and manufacturing. Full-year GDP growth of 6.1% was driven primarily by private consumption and a welcome boost in investment (Figure 3.24.1).

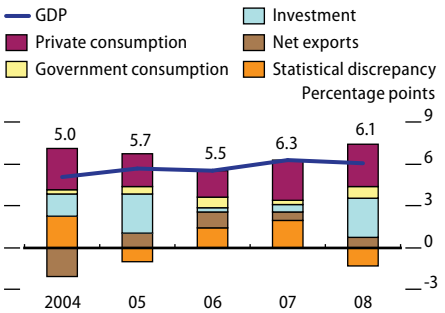
Private consumption, which accounted for 57% of GDP and about half of GDP growth, grew by 5.3% in 2008, a little faster than the 5.0% of 2007, despite rising food and fuel prices. Spending on durable goods was buoyant for much of 2008, supported by an expansion of consumer finance. Sales of motorcycles for example, most of which were bought on credit, rose by 32.6%.

Investment put in one of the best performances for many years. Growth in gross fixed capital formation accelerated to 11.7%, and its ratio to GDP increased to 23.7% after a decade of weakness (Figure 3.24.2). Nearly three quarters of the fixed investment went into buildings, although growth in this category eased to 7.3% relative to 2007. In contrast, investment in machinery and equipment rose by about 25.3%. Realized foreign direct investment (FDI), excluding that in oil, gas, and some other industries, increased by about 44% to $14.9 billion, mainly into transport and communications. Total investment contributed a substantial 2.8 percentage points of total GDP growth. Net exports added 0.7 percentage points.

From the production side, growth of services (44% of GDP) picked up to 8.9%, contributing more than half the total expansion (Figure 3.24.3). The communications subsector continued to accelerate, reflecting demand for mobile telephone services, which have risen from a low base a decade ago to an estimated 138 million subscribers.

Industry grew by 3.7%, its slowest rate in 7 years, and contributed 1.6 percentage points of total growth. The deceleration was caused in part by weaker growth in manufacturing. This subsector was hurt late in the year by a softening in external demand and a squeeze on domestic credit,

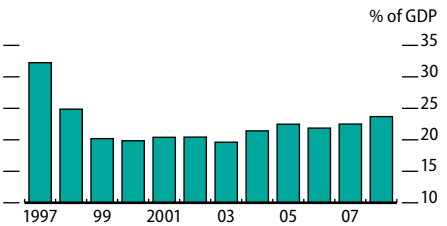
3.24.1 Contributions to growth (demand)



Sources: Asian Development Outlook database; Statistics Indonesia, available: http://www.bps.go.id, downloaded 17 February 2009.

Click here for figure data

3.24.2 Real gross fixed capital formation



Sources: Asian Development Outlook database; CEIC Data Company Ltd., downloaded 17 February 2009.

Click here for figure data

This chapter was written by Jörn Brömmelhörster and Priasto Aji of the Indonesia Resident Mission, ADB, Jakarta.

notably credit for working capital. Power shortages in some cities, due to underinvestment in generation, also hindered factory output.

Manufacturing has faced problems for several years: exports of textiles, electronics, footwear, pulp and paper, and wood products have stagnated even as the world market expanded, suggesting that Indonesia is becoming less competitive. The country's exports have, in fact, become more dependent on volatile world markets for mineral and agricultural commodities. The mining and quarrying subsector (which includes oil and gas) last year grew a torpid 0.5%, even though global prices for metals and energy were high in the first half. Underinvestment, especially in oil extraction, has limited the supply response to higher prices. Oil production has fallen during the past decade, although it started to pick up last year. In other industry subsectors, utilities and construction maintained fairly solid growth in 2008.

Agriculture's share of the economy is relatively small at 14%, but it employs 41% of the work force. Farm production climbed by 4.8% in 2008, well above its average growth rate in recent years. This outturn was helped by unusual rains in the dry season and an expansion of output from rubber and palm oil plantations attributable to high global commodity prices. Rice production rose by 5.5% to 38.6 million metric tons of milled rice, thus meeting a government self-sufficiency target of 37 million metric tons. Government subsidies for hybrid seeds and fertilizer, as well as the good weather, spurred rice production.

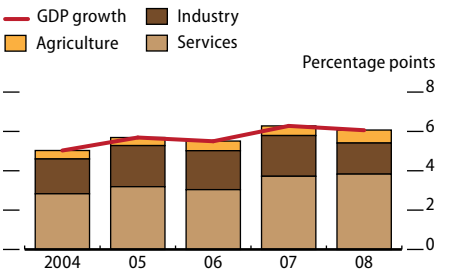
Merchandise exports in nominal terms rose by 18.0% to $139.3 billion for the whole year 2008 on account of higher global prices for commodities, including coal, oil and gas, palm oil, and rubber. However as the global downturn deepened, total exports dropped by 8.5% in the fourth quarter from the prior-year level (Figure 3.24.4).

Merchandise imports surged at double the pace of exports in 2008, to $116.0 billion, reflecting higher prices for commodity imports (including oil), and buoyant domestic demand for much of the year. Import growth braked sharply in the fourth quarter, though. On these developments, the full-year trade surplus fell by 28.8% to $23.3 billion. After deficits for trade in services ($13.0 billion) and in the income account ($15.3 billion) are included, the current account surplus fell to $606 million (0.1% of GDP).

Portfolio investment outflows in the second half of 2008, prompted by rising risk aversion and heightened demand for liquidity worldwide, contributed to a deficit of $1.7 billion in the capital and financial account. The overall balance of payments was in deficit by $1.9 billion. International reserves fell by $5.3 billion over 2008 to $51.6 billion (4.3 months of imports of goods and services), in part a result of the capital outflows and of central bank sales of foreign exchange to support the rupiah. Total external debt as a share of GDP was about 34%, steady with 2007, but down from 55% in 2004. The debt service ratio over the 4-year period fell to an estimated 18% from 27.1%.

Spurred by rising global prices of oil and food, inflation nearly doubled from 6.6% year on year in late 2007 to a peak of 12.2% in September 2008. Bank Indonesia eventually responded to the inflation surge and raised its policy interest rate between May and October, from 8.0% to 9.5%. Inflation eased a little to 11.1% by year-end (Figure 3.24.5), for a year-average rate of 10.3%. As global commodity prices fell back

3.24.3 Contributions to growth (supply)



Sources: Asian Development Outlook database; Statistics Indonesia, available: http://www.bps.go.id, downloaded 17 February 2009.

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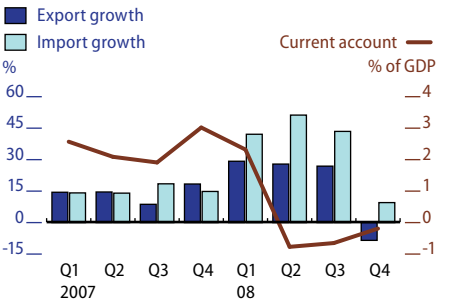
3.24.4 External indicators



Source: CEIC Data Company Ltd, downloaded 10 March 2009.

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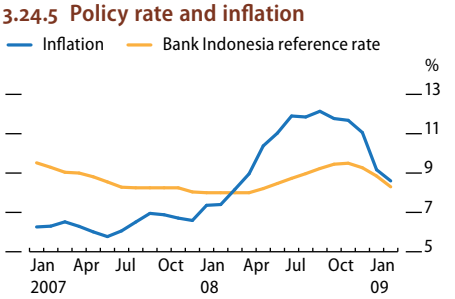
3.24.5 Policy rate and inflation



Note: Break in inflation series starting June 2008.

Sources: Bank Indonesia, available: http://www.bi.go.id; CEIC Data Company Ltd., both downloaded 17 February 2009.

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and economic growth decelerated in the fourth quarter, the central bank had room to lower its policy rate, by 175 basis points to 7.75% between December 2008 and March 2009.

Broad money (M2) growth averaged 16.1% for the year, in a gradual slowing from 2007 as the central bank reduced excess liquidity in the banking system. Growth in credit to the private sector remained high for most of the year, adding to demand-side price pressures (Figure 3.24.6).

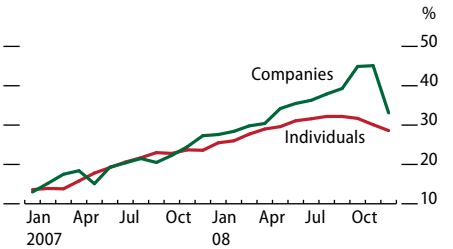
The rupiah was firm against the United States (US) dollar until the last quarter, when capital outflows contributed to a sharp depreciation and prompted Bank Indonesia to intervene in the foreign exchange market to support the currency. The year-average exchange rate against the dollar depreciated by about 6% relative to 2007, and the real effective exchange rate depreciated by 4.6%.

Yields on government bonds shot up during the global exodus from emerging markets in September and October. They came off those peaks later, but at end-2008 were still well above year-earlier levels (Figure 3.24.7).

Soaring oil prices in the first half of 2008 boosted the cost of government subsidies of fuels and electricity by about $3 billion against the planned budget target. To contain the rising cost of subsidies, the Government raised the administered prices of fuels in May by nearly 29%. It provided cash compensation to 70 million of the country's poor and near-poor to cushion the impact of the higher costs of fuel and food. The sharp slide in global oil prices late in 2008 enabled the Government to lower the price of gasoline in December and again in January 2009. Fuel prices remain administered, but the Government has introduced a monthly price review to avoid large one-time changes and to better control the impact of subsidies on the budget. Outlays on subsidies claimed 27.9% of total government expenditure last year.

Revenue collection has increased substantially in recent years to reach the equivalent of about 20% of GDP, achieved through widening the tax net, improving tax administration, and targeting the booming commodity sectors. Last year, total government revenue rose by 38.6% and total expenditure by 30.1% (Figure 3.24.8). The fiscal deficit narrowed to 0.1% of GDP, the smallest gap in 12 years.

3.24.6 Growth of private sector credit



Note: Data refer to commercial bank credit.

Source: CEIC Data Company Ltd., downloaded 11 March 2009.

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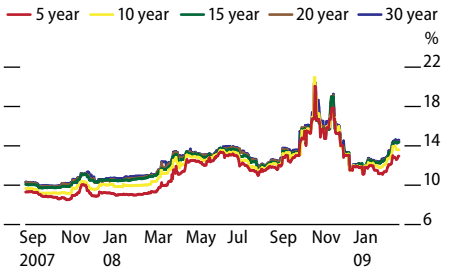
3.24.7 Government bond yields



Source: Bloomberg, downloaded 4 March 2009.

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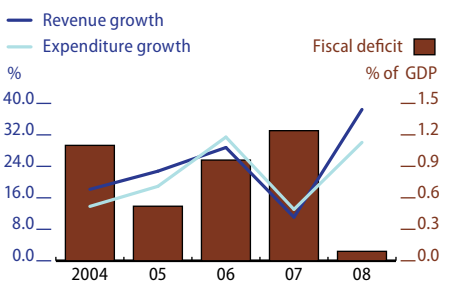
Economic prospects

Given the gloomy international outlook and easing inflation pressures, the forecasts assume that the Government will increase its emphasis on stimulating economic growth this year and next, while keeping the fiscal deficit to prudent levels. It can do this in part because better macroeconomic management and a stronger financial sector have put the economy in better shape than it was in the 1997–98 financial crisis. Low levels of public debt and the tight rein on the fiscal deficit in recent years provide scope for fiscal stimulation and the domestic banking sector is on a stronger footing.

The forecasts also assume that the central bank will have room to further reduce interest rates and that it will maintain banking system stability. Normal weather and absence of economically damaging natural disasters are also assumed.

3.24.8 Fiscal indicators



Sources: Ministry of Finance; *Asian Development Outlook* database; staff estimates.

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Both domestic and external demand will slow sharply this year. The external sector is expected to be a drag on growth. On the domestic side, which provided nearly all the GDP growth in 2008, private consumption growth will slacken as the labor market weakens, remittances from Indonesian workers abroad subside, and rural incomes decline. Agriculture is unlikely to grow as strongly as in 2008, when unusual rains and rising commodity prices boosted production. Forecast lower inflation in 2009 will to some degree offset these consumption-damping influences. Also, government consumption expenditure is expected to increase, a result of a fiscal stimulus package approved in February 2009 (Box 3.24.1), coupled with additional spending ahead of parliamentary elections in April this year and presidential elections in July.

Private investment will diminish in the face of subdued domestic and external demand and lower profits. Further, banks have been generally more cautious in lending since the economy started to slow. Some investment projects are likely to be postponed. The Government is taking steps to provide credit guarantees for certain infrastructure projects, but its allocations so far are low relative to overall infrastructure needs.

On the balance of these factors, GDP growth is forecast to slow to 3.6% in 2009, but pick up to 5.0% in 2010 (Figure 3.24.9), if the global economy recovers in the second half of 2010 as assumed.

Weaker domestic demand and lower prices for fuel and commodities trimmed inflation to 8.6% in February 2009, and producer-price inflation has also eased. These trends are expected to continue, bringing year-average inflation down to 6.3% this year and possibly leaving scope for a further reduction in interest rates.

With major trading partners the European Union, Japan, Korea, Singapore, and the United States in recession or headed in that direction, merchandise exports are expected to fall by at least 25% in 2009. January bodes ill for the year: they plunged 36.1% (Figure 3.24.10). For the year, average prices of most export commodities will be below last year's levels.

Import growth will slow too, along with weaker domestic demand and lower commodity prices. The trade surplus is forecast to decline to around $15 billion and the income and services accounts will remain in deficit. Remittances are projected to decline as labor markets weaken in host countries. The current account is likely to be in deficit in 2009, before returning to surplus in 2010.

A government drive to arrange external financing has bolstered the overall balance of payments. It has reached agreement with development partners to access more than $5 billion of standby loans, if conditions in international capital become too restrictive. The Government expects that the standby loans will underpin market confidence and enable it to meet financing requirements from market sources.

The authorities also moved quickly to raise funds through domestic and international bonds. They sold $3 billion in 5- and 10-year notes in February 2009 (but paying more than 8 percentage points above the comparable US Treasury yield) and sold Rp5.56 trillion ($467 million) of Islamic financial certificates, or *sukuk* bonds. Furthermore, Indonesia has access to $13.7 billion under currency swap arrangements that provide additional assurance for international reserves.

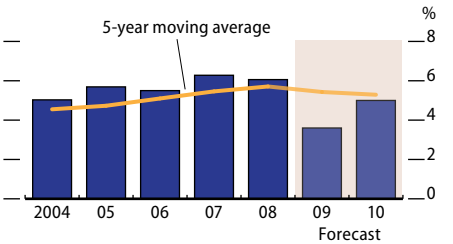
Reflecting the strengthening of the banking system since the Asian

3.24.1 Selected economic indicators (%)

	2009	2010
GDP growth	3.6	5.0
Inflation	6.3	6.9
Current account balance (share of GDP)	-0.6	0.8

Source: Staff estimates.

3.24.9 GDP growth



Sources: Ministry of Finance; *Asian Development Outlook* database; staff estimates.

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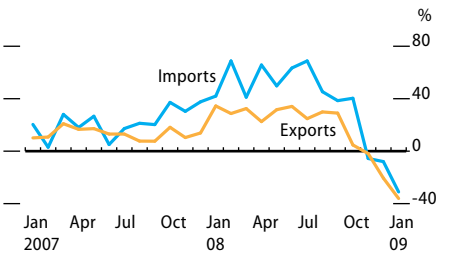
3.24.10 Merchandise trade growth



Note: Based on customs data.

Source: CEIC Data Company Ltd., downloaded 6 March 2009.

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financial crisis, capital-adequacy ratios are now generally high and the ratio of nonperforming loans was 3.8% in December 2008. Still, given strong, nearly 32% growth in lending last year, the economic slowdown will likely result in somewhat higher levels of nonperforming loans in the forecast period. The Government has expanded deposit insurance on rupiah and US dollars deposits of up to Rp2 billion ($165,000) per account since October 2008 to strengthen confidence in the banks.

Possible delays in implementing the fiscal stimulus are a risk to the above forecasts. Budgeted outlays are often not spent until the second half of the year. Delays in disbursements would be particularly harmful now, when timely action is required. The tax waivers in the package can be implemented quickly, though. Another risk is a sharper depreciation of the rupiah. This would push up prices of imports and could further erode domestic demand. Finally, consumption will be more deeply affected if job layoffs are more widespread than expected.

Development challenges

Protecting the poor will be a high priority during the economic slowdown. More than 55% of the working population lives on less than $2 a day, so these people are vulnerable to even a small loss in income. Poverty incidence, which fell from 16.6% in March 2007 to 15.4% in March 2008, is expected to slow its decline this year.

The unemployment rate is forecast to rise above 9% as layoffs spread domestically and more overseas workers lose their jobs and return home. Underemployment will likely exceed 30%. Still more people will be pushed into the informal sector—it already accounts for about two thirds of the labor force—where wages are low and job security weak.

To protect the most vulnerable groups, the Government is extending the community empowerment program that has been useful in improving basic services. It also could build on cash transfer programs, which worked well in 2008 to compensate the poor for higher fuel and food prices.

Over the longer term, the private sector would be in a position to play a greater role in creating jobs if the Government accelerated reforms to improve the business climate. Constraints to private sector expansion include poor infrastructure, uncertain laws and their implementation, and governance issues, including corruption.

Decentralization of policy making from the center to local administrations since 2001 has complicated conditions for businesses because local policies are not always coordinated with those in Jakarta. Furthermore, delays in implementation of development policies are often traced to regional governments, which now manage about 30% of the total government expenditures but do not always have the capacity to carry out major programs.

3.24.1 Fiscal stimulus

The fiscal stimulus package totals Rp73.3 trillion (1.4% of GDP), or $6.5 billion. Supplementing the original budget, it is to be carried out this year. Nearly 35% of the package is to support private consumption through waivers of income and value-added taxes and through subsidies for cooking oil and generic medicines.

Assistance for industry (about 50% of the package) includes tax breaks, waived import duties, a subsidy on diesel, discounts for electricity, and support for trade finance. Infrastructure projects (about 13% of the package) focus on labor-intensive works involving water supply projects, low-cost housing, roads, and ports. Funds will be allocated to extend the community empowerment program (about 1% of the package), which encourages village-level participation in planning and carrying out rural infrastructure, education, and health projects.

According to official estimates, the extra spending will widen the fiscal deficit to 2.5% of GDP this year.

Such a deficit appears manageable, particularly as part of it will be financed by unused budget outlays from last year. Total central government debt at end-2008 was $149.5 billion, or a relatively low 33% of GDP, and most of it is long term.

Lao People's Democratic Republic

Expansion of mining, hydropower, and services maintained robust economic growth in 2008, in a context where inflation accelerated initially, but slowed later in the year. The global economic slowdown is expected to reduce growth in 2009 through its impact on trade, tourism, and foreign investment. An immediate need is to ensure macroeconomic stability and safeguard progress achieved in recent years, including reductions in poverty. The gradual improvements in trade and investment conditions, prompted by the preparations to join the World Trade Organization, should help in that regard.

Economic performance

Solid economic growth of 7.2% in 2008—similar to the average of the previous 5 years—was based on continuing expansion of industry (especially mining and hydropower), and services. Industrial production grew by 10.2%, with increases in copper and gold mining output, power generation, and construction. Production of copper rose by 42% to about 89,000 metric tons and of gold by 4.1% to about 4.3 metric tons (Figure 3.25.1). Output of both was boosted in April 2008 when the Phu Kham copper and gold mine started production. Hydropower output rose by 5.7%, mainly a result of higher rainfall in water-collecting areas.

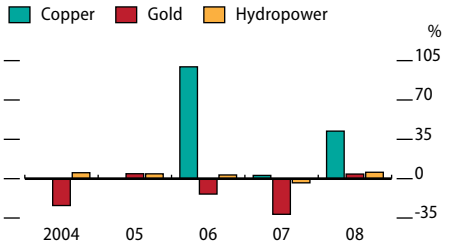
Services expanded by 9.7% and contributed more than half of total GDP growth (Figure 3.25.2). Subsectors to grow included finance, with the opening of four new commercial banks and expansion of two others, wholesale and retail trade, government services, and transportation and communications. However, tourist arrivals rose by just 1%, damped by the global economic slowdown and political instability in neighboring Thailand.

Agriculture, which employs over 70% of the labor force, was hit by severe floods in late August that damaged 10% of the arable area and curtailed production of rice and vegetables. Production increased, though, of tree crops (including coffee), livestock, and fish farming, lifting total agricultural output by 2.0%.

Early in the year, higher global prices for food, oil, and fertilizer spurred inflation, which peaked at 10.3% year on year in May 2008 (Figure 3.25.3). The Government took steps to cushion the impact of higher imported inflation. It froze the price at which it levies duties and other taxes on petroleum products at April 2008 levels; imposed a ban on exports of glutinous rice, the staple rice (partly relaxed in November); and regulated prices of some other consumption goods.

The Bank of the Lao PDR let the kip gradually appreciate against the US dollar (by 10.3% in 2008) and the Thai baht (by 15.2%; about 70% of the country's imports are from Thailand). Inflation decelerated later in 2008 when global oil and food prices eased, leaving the year-average rate at 7.6%, well up from 2007 but below the average for 2003–2007.

3.25.1 Energy and mineral production growth



Sources: Ministry of Energy and Mines, Lao PDR; US Geological Survey, available: http://http://minerals.usgs.gov; CEIC Data Company Ltd., both downloaded 13 March 2009; Oxiana Ltd., various annual and quarterly reports, available:http://www.ozminerals.com; Pan Australian Resources Ltd., various annual and quarterly reports, available: http://www.panaust.com.au.

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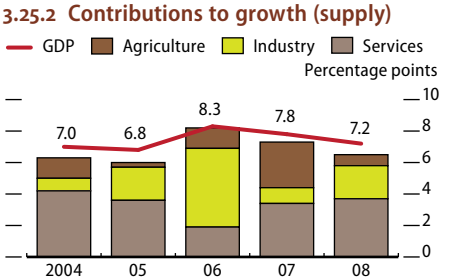
3.25.2 Contributions to growth (supply)



Sources: Asian Development Outlook database; Department of Statistics of the Lao PDR.

Click here for figure data

This chapter was written by Christopher Hnanguie and Soulinthone Leuangkhamsing of the Lao Resident Mission, ADB, Vientiane.

The fiscal deficit (excluding grants) widened to an estimated 5.8% of GDP in FY2008 (ended 30 September 2008) (Figure 3.25.4). Expenditures rose to the equivalent of 20.5% of GDP. Revenue rose to 14.7% of GDP, from 14.0% in FY2007, exceeding the target for a second consecutive year. A recentralization of tax collection to the central Government from the provinces has helped revenue efforts over the past couple of years, as has improved tax enforcement and an increase in tax and royalty collections from mining (about one third of all government revenue).

A debt-sustainability analysis conducted by development institutions in June 2008 noted that external public debt declined to about $2.4 billion at end-2007, for a still-high 59.5% of GDP, from 77% of GDP 2 years earlier. Most of the debt is to multilateral development banks and the Russian Federation, and is on concessional terms.

Merchandise exports are dominated by copper and gold, followed by clothing, power, and coffee. Increased exports of these two metals drove an estimated 21.2% rise in total merchandise exports in 2008, despite weakness in the fourth quarter as a result of the slump in global copper prices (Figure 3.25.5). Clothing exports rose by 15% in 2008. Merchandise imports climbed by an estimated 11.9%, the higher cost of imported fuel being a major factor. The current account deficit widened to 18.9% of GDP. After inflows of foreign direct investment and grants, the overall balance of payments was in surplus for the first 3 quarters (the latest available data). Gross international reserves rose by almost 19% to $622 million, sufficient to cover 5 months of non-resource-related imports.

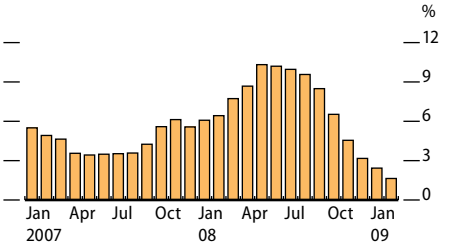
Banking, while still underdeveloped, has expanded since the Government approved a commercial banking law in 2006. In addition to three state-owned commercial banks, there are now two public–private banks, two domestic private commercial banks, and nine foreign bank branches. The state-owned commercial banks account for 59% of total banking assets, although their share is declining. Lending to the private sector more than doubled in 2008 to the equivalent of 15% of GDP. The central bank lowered its policy interest rate in three steps, from 12% to 7%, to stimulate borrowing.

Although the ratio of nonperforming loans to total loans has come down from high levels over recent years, loan quality is expected to deteriorate as the economy slows. Further progress is needed to recapitalize the state-owned commercial banks (their capital-asset ratio was 0.42% last year, compared with 15.6% for private banks) and to strengthen bank risk assessment and supervision.

Preparations to join the World Trade Organization (WTO) in 2010 were stepped up last year, with the formation of a new body to coordinate the effort and to oversee associated trade-related reforms. Laws and regulations are being changed to meet WTO requirements. The Government added an offer on market access to services to its offer on market access to goods that it submitted in 2007.

The private sector continued to develop gradually. Laws to promote business and investment that were passed some time ago are being implemented. A special economic zone is being trialed in Savannakhet province, aimed at promoting foreign and domestic investment, attracting technology and skills, and generating jobs. Faster private sector growth is retarded by poor infrastructure, cumbersome regulations, limited

3.25.3 Monthly inflation



Source: Bank of the Lao PDR, available: www/bol.gov.la, downloaded 13 March 2009.

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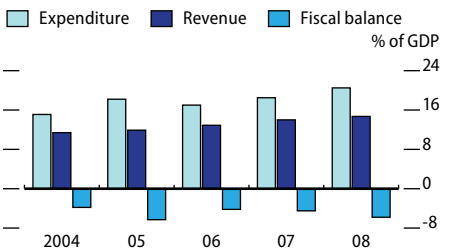
3.25.4 Fiscal indicators



Sources: Asian Development Outlook database; Ministry of Finance, Lao PDR.

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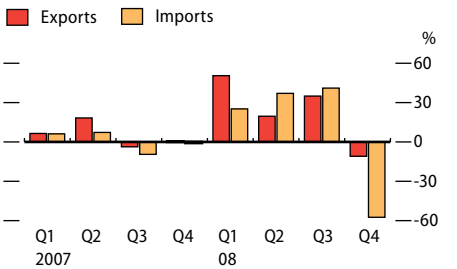
3.25.5 Growth of merchandise trade



Sources: CEIC Data Company Ltd., downloaded 13 March 2009; staff estimates.

Click here for figure data

availability of skilled labor and finance, and inadequate land security. Boosting private activity will need a switch from the system of business licensing to one of business registration. Similarly, there is a need to enhance transparency, simplify, and define tax procedures. Another hindrance to firms is business customers' high power tariffs. In finance, the banks could assist development of small and microenterprise startups that have solid business proposals by simplifying lending procedures and clarifying which assets can be used as collateral.

Economic prospects

Growth will slow in 2009 and 2010 as the global economic downturn hits exports of clothing and copper, as well as tourism. Orders for clothing exports in early 2009 were down by 15–20%. Foreign direct investment is expected to diminish in the face of weaker prices for metals (particularly copper) and tighter international funding. Several planned projects have been delayed, including expansion of a copper and gold mine and work on three new hydropower stations. Slower export growth will curtail incomes and consumption spending, and weigh on business confidence and investment.

On the positive side, government spending on facilities for some special events will contribute to growth. The Southeast Asian Games are scheduled to be held in Vientiane late this year and the 450th anniversary celebrations for Vientiane as the capital will be held in January next year. Assuming reasonable weather, agricultural production is forecast to expand faster this year than last, when floods damaged crops. Irrigation systems are gradually improving and additional bank credit is being made available to bolster farm output. The 1,082 megawatt Nam Theun 2 hydropower project, the country's biggest, comes into full commercial operation late in 2009.

Furthermore, the Government is preparing measures to cushion the economy from the impact of the global slowdown. These include provision of credit and other support for small and medium-sized enterprises and temporary reductions in power tariffs for mining companies that face cash-flow difficulties. It is also considering suspending a 10% value-added tax that came into effect on 1 January this year. On the monetary side, the central bank is prepared to support credit for farmers and small firms.

On these factors, GDP growth is expected to decelerate to 5.5% in 2009 and stay close to that rate in 2010 (Figure 3.25.6). Year-average inflation is projected to ease to 5.0–6.0% in the forecast period (Figure 3.25.7). Lower average global oil and food prices this year will put downward pressure on inflation, though this impact is expected to be partly offset by other influences, notably the value-added tax (unless it is suspended). The current account deficit is forecast to be around 16% of GDP (Figure 3.25.8). International reserves will likely decline further as foreign direct investment and remittance inflows wane.

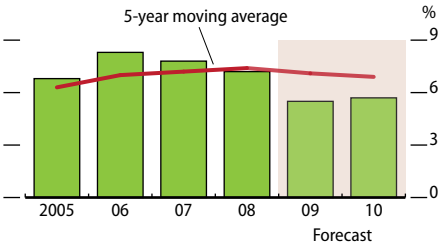
The Government plans to lift spending in FY2009 by about 10%. However, its revenue will slip by at least that rate as a result of the slump in global copper prices as well as the likely suppression of tax revenue caused by slower economic activity. The fiscal deficit is expected

3.24.1 Selected economic indicators (%)

	2009	2010
GDP growth	5.5	5.7
Inflation	5.0	6.0
Current account balance (share of GDP)	-15.9	-16.0

Source: Staff estimates.

3.25.6 GDP growth



Sources: Asian Development Outlook database; staff estimates.

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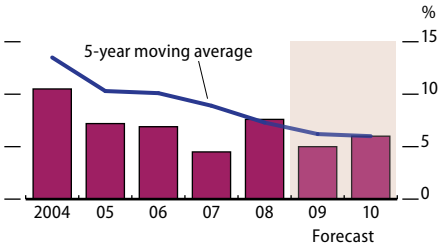
3.25.7 Inflation



Sources: National Statistics Center, Lao PDR; Bank of the Lao PDR, available: http://www.bol.gov.la, downloaded 18 March 2008; staff estimates.

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to widen to about 5% in 2009. The authorities are therefore looking at ways to reprioritize spending so as to put more emphasis on supporting growth. In this situation, it may divert planned spending on social development, such as health and education. Fiscal strains are likely to intensify in FY2010, given the weakness in revenue and the likely need to support growth.

Risks to the above forecasts include cutbacks in mining production and the related possibility of more serious erosion than expected in government receipts. Expansion of credit by state-owned commercial banks last year, coupled with the slowing economy in 2009, raises the risk of higher nonperforming loans, which in turn could lead banks to be more cautious in their lending.

Development challenges

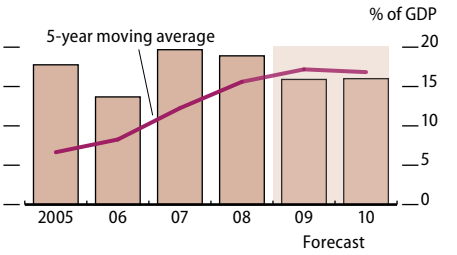
The immediate priority is to ensure macroeconomic and financial stability, and to prevent the global economic fallout from unraveling past achievements. Poverty incidence, for example, has declined, from 33% in 2002 to around 28% in 2008. At a time when the economy is slowing and vulnerable groups need to be protected, changes in budget priorities put at risk funding for social development and poverty reduction.

Other achievements that need to be upheld include the increased momentum in economic growth (averaging 7.5% over 5 years), suppression of formerly double-digit inflation, and the strengthened fiscal position. Monitoring the impact of the slowdown on the economy to enable sound policy making will require improvements in the timeliness and reliability of economic and financial data.

Closer commercial links with neighboring countries in recent years provide greater opportunities for the country to access outside markets, technology, and capital. Indeed, investment and trade have surged, mainly involving natural resources (mining, hydropower, and agriculture). It is now important to ensure that development of natural resources is environmentally sustainable.

A more diversified economy would generate more employment than is possible through mining and power generation, and would reduce vulnerability to volatile global commodity prices. In this regard, improving the environment for private sector development is key. That requires addressing constraints referred to above. Shortages of skilled labor indicate that education and training should be high on the list of priorities for investing the public revenue from minerals and hydropower. Related to skill shortages is weakness in public services because, although the Government has rolled out reforming policies, it has very limited capacity to carry them through, in particular at the local level.

3.25.8 Current account deficit



Sources: Asian Development Outlook database; staff estimates.

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Malaysia

Growth in this trade-sensitive economy came to a virtual halt in the second half of 2008 as the global environment deteriorated. Inflation began to moderate in tandem with slowing growth. With external demand looking bleak, GDP is likely to contract this year, before resuming growth in 2010. The authorities have pushed through fiscal and monetary measures to support domestic demand. In view of the large current account surplus, substantial foreign reserves, and disinflation, the Government has scope to stimulate the economy without endangering macroeconomic stability.

Economic performance

Intensification of the global economic downturn in the second half of 2008 was a major factor in slowing GDP growth sharply, as exports and industrial output declined, and the momentum in services growth eased. GDP rose by just 0.1% year on year in the fourth quarter of 2008, the lowest rate since the third quarter of 2001 and down from 7.4% in the first quarter of 2008 (Figure 3.26.1). Strong growth in the first half resulted in an expansion of 4.6% for the year as a whole, below the average 6.0% rate in the previous 5 years.

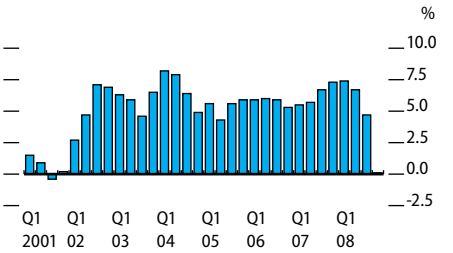
Growth in services, which account for 54% of GDP, slowed from a hectic pace as overall economic activity moderated, but still expanded by 7.3% in 2008. This rate was higher than the average performance in recent years, and was supported by wholesale and retail trade, finance and insurance, and government services, which together account for about 31% of GDP. Services contributed about 4 percentage points of total GDP growth.

Industry, making up 39% of GDP, posted weak growth of 0.9%. Manufacturing, the main subsector, slowed significantly with the downturn in external demand. Although production for the domestic market held up fairly well, output of export-oriented manufacturing, such as electronics, contracted in the second half. Mining production was also weak, as the increase in oil output was largely counterbalanced by the decline in natural gas production as a result of repair and maintenance of some plants and pipelines.

Solid growth of 3.8% in agriculture (about 7% of GDP) reflected a healthy rise in output of livestock, fisheries, fruits, vegetables, paddy, and, in the first half of the year, palm oil.

Consumption provided the impetus to growth in aggregate demand (Figure 3.26.2). Private consumption (just over half GDP) grew by a buoyant 8.4% in 2008. It benefited from an increase in rural incomes that stemmed from high commodity prices in the first half of 2008; low real interest rates; more intense competition among retailers, especially hypermarkets; and a substantial increase in civil servants' salaries in July 2007. A stable labor market supported private consumption: the

3.26.1 GDP growth



Sources: Asian Development Outlook database; CEIC Data Company Ltd., downloaded 27 February 2009.

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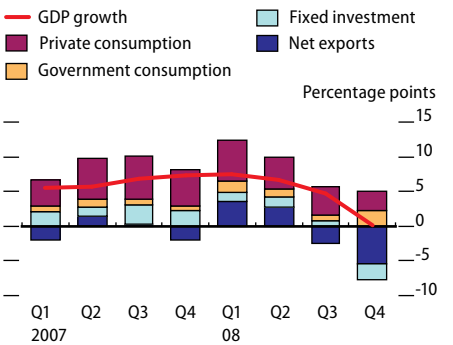
3.26.2 Contributions to growth (demand)



Sources: CEIC Data Company Ltd.; Bank Negara Malaysia, available: http://www.bnm.gov.my, both downloaded 27 February 2009.

Click here for figure data

This chapter was written by Sharad Bhandari of the Southeast Asia Department, ADB, Manila.

unemployment rate was 3.1% in the third quarter, unchanged from a year earlier. (However, employment as a share of the working-age population declined from 61.4% to 60.9% over the period with a fall in the labor-force participation rate, indicating an increasing number of people dropping out of the workforce.)

Government consumption rose by 11.6%, reflecting primarily the higher salaries for civil servants. The contribution of net exports to GDP growth fell as the global downturn worsened, but domestic demand and hence imports were more resilient. For the year as a whole, net exports subtracted 0.5 percentage points from overall GDP growth.

After 2 years of strong growth, fixed investment slowed sharply last year. A steady deterioration in the global economic environment, particularly weakness in demand for electronic products, and domestic political uncertainty crimped investment growth. (The ruling coalition lost its two-thirds majority in the National Assembly in the March 2008 elections.) Fixed investment declined to 19.7% of GDP in 2008 from an average 21.3% of GDP in the previous 5 years (Figure 3.26.3).

Much of the moderation in fixed investment in 2008 appeared to reflect subdued private investment, while public investment was supported by projects under the Ninth Malaysia Plan 2006–2010. Federal government capital spending rose by 21% during the first 3 quarters of 2008.

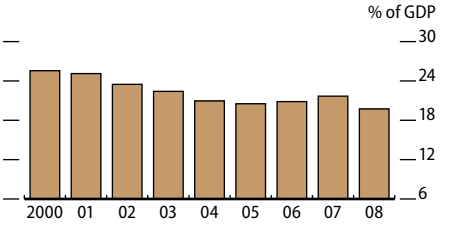
Merchandise exports in nominal ringgit terms fell from year-earlier levels in the last quarter (Figure 3.26.4) as global demand weakened and prices of most commodity commodities dropped. For the full year though, exports were up 9.6%, boosted by an increase of almost 40% in major commodity exports, especially palm oil, petroleum, and natural gas. Resource-based manufactured exports, such as food, petroleum products, and rubber, as well as chemical products, also rose strongly. The rise in these exports more than offset continued weakness in electrical and electronic exports (42% of total exports).

Imports posted modest 3.3% growth in 2008, reflecting the import-intensity of electrical and electronic exports (imports of electrical and electronic components account for more than a third of total imports), softer prices of manufactured imports and, in the latter half of the year, the slowdown in domestic demand.

The consequent rise in the trade surplus helped raise the current account surplus to an estimated 17.9% of GDP. The services account retained a reasonable, albeit lower, surplus in the first three quarters of 2008 (the latest data available). A services surplus had been realized for the first time in 2007, partly owing to a strong increase in tourism receipts as a result of promotional activities, including Visit Malaysia Year. These receipts remained buoyant in 2008, though growth decelerated. The income and transfers accounts are likely to have recorded deficits of 2–3% of GDP, as in 2007.

The overall balance of payments posted a deficit for the year as a whole. Net portfolio investment outflows accelerated in the second half, reflecting more intense risk aversion and deleveraging by international investors. Inward foreign direct investment flows moderated and direct investment abroad by Malaysian companies continued to increase, leading to a net outflow (Figure 3.26.5). International reserves fell by about $12 billion during the year to $89.8 billion, sufficient to cover

3.26.3 Fixed investment ratio



Source: Asian Development Outlook database.

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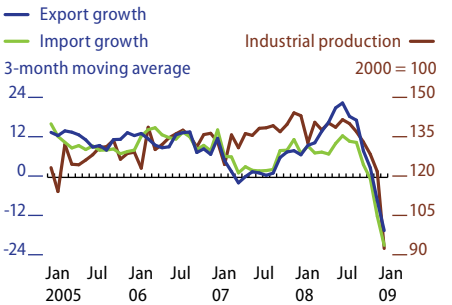
3.26.4 Trade and industrial production



Note: Exports and imports based on customs data.

Source: CEIC Data Company Ltd., downloaded 13 March 2009.

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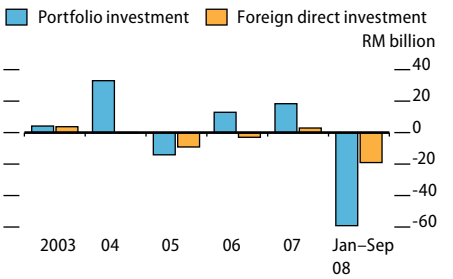
3.26.5 Net investment



Source: CEIC Data Company Ltd., downloaded 27 February 2009.

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6 months of imports and more than three times the level of short-term external debt.

The reduction in net foreign assets thus subtracted from liquidity growth toward the end of the year, in contrast to earlier months (Figure 3.26.6). However, M3 growth slowed only slightly, with a rise in the financial system's net claims on government (reflecting an expansionary fiscal stance) taking up some of the slack.

Inflation spiked in June 2008 to 7.7%, largely a result of a reduction in fuel subsidies. It peaked in July, when electricity tariffs were raised (Figure 3.26.7.) Subsequently, the fall in global commodity prices, along with slowing domestic demand, eased inflation pressures. Still, average inflation for the year was 5.4%, more than double the average of the previous 5 years.

The central bank, Bank Negara Malaysia, took several steps to ensure financial stability and support growth. It provided, in October 2008, full guarantees on local and foreign currency deposits of financial institutions through end-2010 in order to thwart potential instability in the financial system as the global credit crisis intensified. As the growth outlook deteriorated, leading to expectations of a steady deceleration in inflation, the central bank also eased its monetary policy stance. From November 2008 to February 2009, it lowered the overnight policy rate by a total of 150 basis points to 2.0%. It accompanied these cuts by lowering the statutory reserve requirement for banks by 300 basis points to 1% of their eligible liabilities.

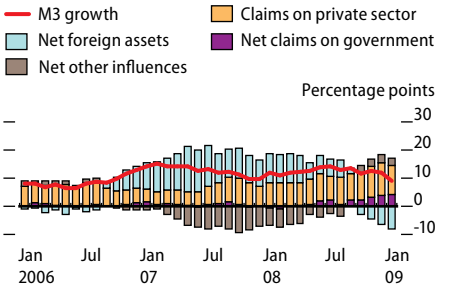
The Government leaned toward a more expansionary fiscal policy. The overall federal fiscal deficit widened to an estimated 4.7% of GDP (Figure 3.26.8). Revenue was boosted by strong first-half economic growth and higher average energy prices (receipts from oil and gas account for over 30% of total government revenue). Expenditure increased more rapidly than expected as a result of higher subsidies and civil service salaries, and, to a lesser extent, greater development spending.

In addition to these more expansionary monetary and fiscal policies, the Government launched measures to attract investment. To ensure smooth implementation of approved projects (in 2003–2008, a significant 77% of approved projects were implemented) and to sustain the interest of investors, the authorities exempted raw materials and intermediate goods for manufacturing from all duties; moved to automatic issuance of manufacturing licenses from December 2008; and established one-stop centers for investors at the local level.

Economic prospects

Malaysia is closely integrated with the global economy: exports of goods and services are equivalent to over 100% of GDP, as are imports. The severity of the global economic downturn and shrinking world trade are expected to tip it into contraction in 2009. GDP is forecast to shrink by 0.2%, the first annual fall in output since 1998. The expected drop in commodity prices from 2008 levels will hurt export earnings and fiscal revenue, but should also damp inflation pressures, bolster the purchasing power of consumers, and enable the diversion of fiscal spending from subsidies to more productive development expenditure. The projections

3.26.6 Contributions to M3 growth



Source: Bank Negara Malaysia, available: http://www.bnm.gov.my, downloaded 4 March 2009.

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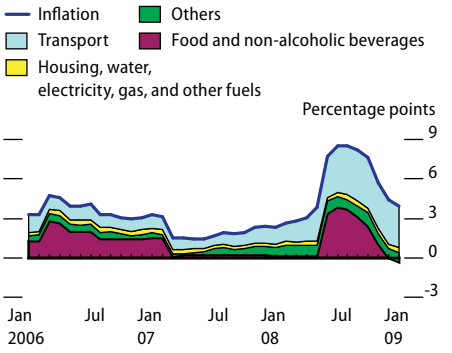
3.26.7 Contributions to inflation



Source: CEIC Data Company Ltd., downloaded 4 March 2009.

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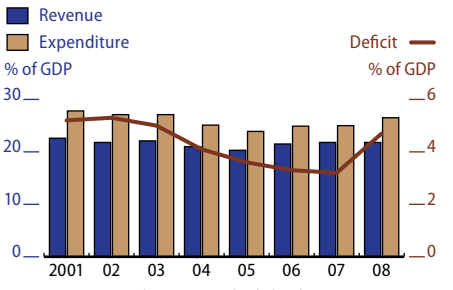
3.26.8 Government finance



Sources: Asian Development Outlook database; CEIC Data Company Ltd., downloaded 27 February 2009.

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for the economy this year assume that the authorities can implement expansionary fiscal policies in a timely manner, and that the political environment remains stable.

Private consumption and government spending are likely to support demand. Private consumption will be assisted by slowing inflation, continued low real interest rates, and a government decision last year to reduce employees' mandatory pension fund contributions for this year and next. These factors will offset some of the adverse impact of the economic slowdown on employment and earnings. Public consumption and investment will no doubt remain strong, given the Government's determination to provide a stimulus. During the midterm review of the Ninth Malaysia Plan last year, the Government significantly increased the allocation for development spending for 2008–2010.

Exports in real terms are likely to contract this year for the first time since 2001, when the global technology bubble burst. This time, the slump in external demand is more severe given the synchronized nature of the global downturn. Imports are likely to decline at a somewhat slower rate than exports, held up somewhat by consumption and public investment. Net exports are therefore likely to subtract from overall demand growth.

The services and agriculture sectors will slow from their robust pace in recent years. Among the major services subsectors, relatively resilient private consumption and continued efforts to promote tourism should offset some of the fallout from the decline in external trade to hold up wholesale and retail trade. Manufacturing, though, is expected to contract, mainly because of the drop in exports. Assuming normal weather conditions, agriculture may expand at close to 4%, supported by government programs to increase food production, including aquaculture.

The current account surplus will narrow in the forecast period (Figure 3.26.9), but at about 14.0% of GDP it will still be large. Merchandise exports are likely to contract more than imports, reflecting the expected fall in global commodity prices as well as lower volumes. The services account is expected to retain a small surplus.

Monetary policy is likely to remain loose as inflation pressures recede, reflecting slower economic growth and excess capacity, falling commodity prices, and lower imported inflation. A reversal in producer prices, from a rise of 14.4% in July 2008 to a decline of 4.5% in January 2009, presages a further moderation of consumer prices. Since the consumer price index is coming off a high base, the year-on-year rate is likely to turn down quite sharply in the second half of this year. The year-average inflation rate is forecast at 1.5%. Expansionary monetary and fiscal policies are expected to keep the economy away from deflation.

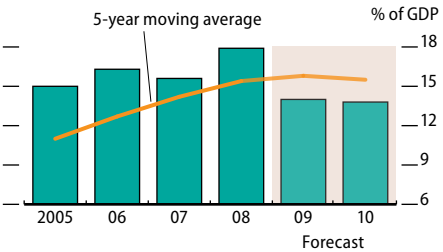
Slower inflation, the large current account surplus, and a comfortable level of international reserves afford the authorities scope to stimulate the economy without jeopardizing macroeconomic stability. The financial system is liquid, with healthy growth in both deposits (9.2% year on year in January 2009) and loans (11.7%). The loan-to-deposit ratio and the financing-to-deposit ratio of 73.4% and 80.9%, respectively, suggest that a higher fiscal deficit can be financed without crowding out the private sector. The banking system's fundamentals are also strong, providing a substantial cushion against the likely adverse impact on banks' balance sheets of the economic slowdown. For example, nonperforming loans

3.26.1 Selected economic indicators (%)

	2009	2010
GDP growth	-0.2	4.4
Inflation	1.5	2.4
Current account balance (share of GDP)	14.0	13.8

Source: Staff estimates.

3.26.9 Current account balance



Source: Asian Development Outlook database.

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have continued to decline to 2.2% of banks' total loans and the risk-weighted capital-adequacy ratio is comfortable at 12.6%.

Bank Negara Malaysia has established an RM2 billion (about US$550 million) facility, which enhances small and medium-sized enterprises' access to financing from February through December this year. The central bank is providing guarantees on financing provided by banks to these firms for up to RM500,000 each and for tenors of up to 5 years. This follows the establishment last year of an RM200 million Micro Enterprise Fund as well as of two other funds to help small companies meet rising costs and to assist in the upgrading of equipment, especially for energy saving. The latter two funds have been fully used.

As the fall in international fuel prices in the latter part of the year obviated the need to provide subsidies, some of these savings were deployed toward an RM7 billion (about 1% of projected GDP) economic stimulus package. It was announced in early November and is to be implemented this year. By March 2009, RM6.5 billion had been channeled to various line agencies to implement the package. The Government expects RM5.2 billion of projects to be under way by June this year.

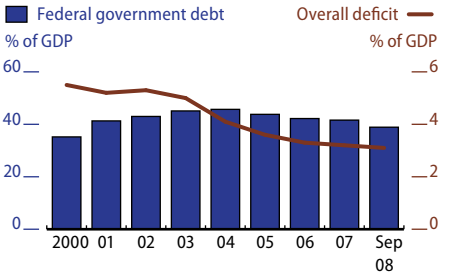
Another RM60 billion (close to 8% of projected GDP) of stimulus measures was announced in March 2009, to be implemented this year and next. These measures include RM25 billion in guarantee funds to provide easier access to capital for companies; an increase in direct budget spending of RM15 billion (of which RM10 billion is allocated for 2009); RM10 billion for equity investments by Khazanah Nasional Berhad (the Government's investment holding company) in subsectors including telecommunications, tourism, and agriculture; RM7 billion in projects under public–private partnerships and other off-budget projects such as the low-cost carrier terminal at the Kuala Lumpur International Airport and expansion of Pulau Pinang airport; and RM3 billion in tax incentives.

Outlays on the stimulus measures and likely sluggishness in government receipts indicate that the fiscal deficit this year may exceed 7% of GDP. Deficits were at least 5% in 2000–2003. Public debt rose from 35% of GDP in 2000 to a peak of 46% in 2004, before trending down to 39% in the third quarter of 2008 (Figure 3.26.10), reflecting the Government's efforts at fiscal consolidation.

Public debt will likely increase over the next few years, but the cost of debt should be manageable as interest rates are somewhat lower than earlier this decade (Figure 3.26.11), reflecting ample liquidity in the financial system and looser monetary policy. Furthermore, 93% of the federal Government's debt comprises domestic debt, mostly held by domestic institutions. (Moody's Investors Service in February 2009 affirmed its A3 rating with a stable outlook on sovereign debt). The likely increase in public debt suggests, though, that fiscal consolidation will need to resume quickly once the economy is on the path to recovery, as it was in 2003–2007.

If the global economy recovers in 2010 and world trade expands in line with global assumptions, the Malaysian economy is expected to resume growth at about 4.4% next year (Figure 3.26.12). The lagged effects of this year's monetary and fiscal stimulus should provide impetus to growth. With firmer external and domestic demand, and the moderate increase in global inflation, consumer prices will likely rise next year by

3.26.10 Fiscal indicators



Source: Bank Negara Malaysia, available: http://www.bnm.gov.my, downloaded 4 March 2009.

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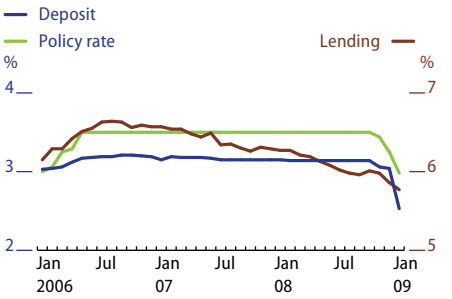
3.26.11 Nominal interest rates



Sources: Bank Negara Malaysia, available: http://www.bnm.gov.my; CEIC data Company Ltd., both downloaded 4 March 2009.

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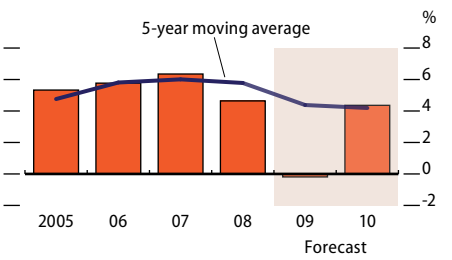
3.26.12 GDP growth



Source: Asian Development Outlook database.

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close to their 10-year average of 2.4%. The current account surplus looks likely to remain at around 14.0% of GDP.

Domestic risks to the outlook are centered on the measures to stimulate the economy—their effectiveness may be compromised if they are not implemented in a timely fashion.

Development challenges

As an upper-middle-income country, Malaysia can no longer rely on low wages and the accumulation of physical capital to sustain the robust levels of growth achieved in the past. Nor can it continue to follow that model to reach its goal of becoming a fully developed economy by 2020. Growth in the future will increasingly depend both on a move into activities that are intensive in knowledge, skills, and technology, and on an increase in total factor productivity.

The midterm review of the Ninth Malaysia Plan published in July 2008 showed that progress was largely on track to meet the targets. (The Plan is further discussed in Box 3.26.1.) In 2006–2007, economic growth averaged 6.1% (the target is 6%), employment rose by 2.2% (the target is 1.9%), and productivity improved as indicated in Malaysia's higher rankings in international comparisons of competitiveness. Incidence of absolute (i.e., food) and overall poverty fell from 2.9% and 5.7%, respectively, in 2004 to 0.7% and 3.6% in 2007. However, the global economic downturn makes it harder to reach the plan targets by 2010.

Eradicating poverty and reducing regional income disparities is another challenge. While the overall poverty rate declined from 22.8% in 1990 to 3.6% in 2007, the rate varies significantly by state, ranging from negligible in Pulau Pinang to a high of 16% in Sabah. The rates are also higher in rural areas (7.1%) than in towns (2.0%). Robust economic growth would help maintain progress in overall poverty reduction, but would probably be insufficient to eradicate remaining pockets of poverty.

To bridge the gap between regions, the Government has planned five development corridors, with the private sector expected to take the lead in developing industries in these areas. Programs to increase access of households in the poorer areas to markets and social services, as well as incentives for firms to invest in those areas, will be important components of the effort to promote equity among regions.

3.26.1 Ninth Malaysia Plan

The Ninth Malaysia Plan 2006–2010 promotes a private sector–led growth strategy to shift the economy up the value chain and boost productivity. Although the share of private investment in GDP rose from 11.3% in 2005 to 11.9% in 2007, it remained relatively modest.

The Government recognizes the benefits of greater private sector participation in the economy in terms of more efficient utilization of resources, innovation in production and distribution, and better service for customers. This underscores the need for continued progress in improving the investment climate so as to encourage private firms to invest and innovate.

In this regard, improvements in the education and training systems are particularly important.

Public–private partnerships envisaged in the Ninth Plan aim to improve the delivery of infrastructure and public services. To the extent that such partnerships entail greater financing by the private sector, their effective implementation would also help reduce the burden on government finances, as well as achieve gains in economic efficiency.

Myanmar

High prices for natural gas exports continued to support modest rates of growth in FY2007. Inflation remained at around 30%, largely the result of money creation to finance fiscal deficits. Recovery and reconstruction after Cyclone Nargis, which inflicted severe human loss and economic damage in May 2008, will take at least 3 years. Economic growth will be diminished this year by weaker performance of Myanmar's major trading partners.

Economic performance

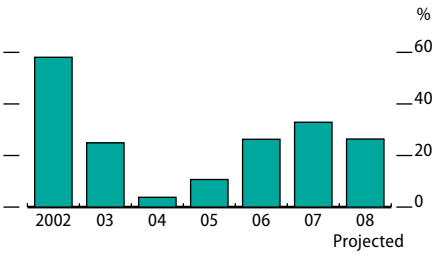
Modest growth and high inflation again characterized the economy in FY2007 (ended 31 March 2008). Official statistics indicate growth in excess of 10% since 2000, but this is not consistent with other variables closely correlated with GDP, such as energy use. Nonofficial estimates put GDP growth at less than half the official estimates. Agriculture remains the dominant sector, contributing about 44% of GDP. Industry, including the natural-gas export segment, accounts for about 20% of GDP, and services the rest. An estimated two thirds of Myanmar's population live in rural areas, often working on small farms or as laborers.

Early on 3 May 2008, Cyclone Nargis hit land at one of the lowest points in Myanmar, setting off a storm surge almost 12 feet high that reached 25 miles inland. The storm laid waste hundreds of villages across large parts of the Ayeyarwaddy River delta, a leading agriculture-producing region, and damaged Yangon, the main city. The cyclone resulted in large-scale casualties, with more than 77,000 people killed, 20,000 injured, and 55,000 still missing. About 2 million people lost their homes and had their livelihoods disrupted. Economic losses were estimated at the equivalent of 2.7% of the officially projected national GDP in 2008.

The Government continued its modest steps to liberalize agriculture. It has ended most production controls and mandatory procurement and, apparently, has eliminated a previous requirement for farmers to grow rice as a dry-season crop in irrigated areas. State enterprises are sourcing more of their agricultural inputs at market prices. Some state enterprises involved in processing and supplying inputs to agriculture have been privatized.

Marketing controls in agriculture have been made less onerous, and farm production has increased in recent years. Although the country used to be a major rice exporter, the Government banned exports of rice and some other farm products in 2004 in an attempt to hold down domestic prices. The rice export ban was relaxed a little in 2006 and eased further in FY2007, when official exports rose to almost 360,000 metric tons (there were also unrecorded exports to neighboring countries). The Government expects another substantial increase in exports in FY2008, despite a 5-month suspension of rice exports following the cyclone.

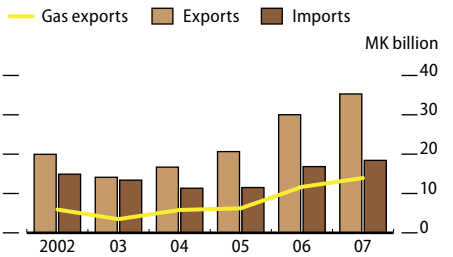
3.27.1 Inflation



Sources: Myanmar Central Statistical Organization, available: www.csostat.gov.mm, downloaded 27 February 2009; staff estimates.

Click here for figure data

3.27.2 Merchandise trade indicators



Source: Myanmar Central Statistical Organization, available: www.csostat.gov.mm, downloaded 27 February 2009.

Click here for figure data

This chapter was written by Pradeep Srivastava of the Southeast Asia Department, ADB, Manila.

The fiscal deficit narrowed to about 3.5% of GDP in FY2007. Rapid growth in tax revenue is a result of improvements to tax administration since 2004, and state enterprises have been increasingly allowed to raise prices closer to market rates. Even with salary increases for civil servants in FY2007, current expenditure was contained. Spending on health and education remains low. However, greater capital outlays, especially on the remote new capital city of Naypyidaw and on the Yangon–Mandalay highway, continue to put pressure on the fragile fiscal position.

Fiscal deficits are financed by central bank money creation, which pushed up broad money supply by nearly 30% in FY2006 and by about 20% in FY2007, in turn propelling inflation to around 30% in both years (Figure 3.27.1 above). Shortages after the cyclone caused short-lived spikes in the price of rice and construction materials.

Rising export income from gas (Figure 3.27.2 above) continues to support the external accounts. The current account surplus was almost 10% of GDP in FY2007. Gross international reserves rose to an estimated $3.4 billion, equivalent to more than 1 year of imports.

Myanmar has a multiple exchange-rate system in which the official rate applies only to transactions undertaken by the Government and state enterprises; it is thus used primarily for accounting purposes. For external transactions, the Government issues foreign exchange certificates, exchangeable at market-determined rates. A large parallel market also flourishes, which exchanges United States dollars for kyats at a small premium over the rate for foreign exchange certificates. This parallel rate was fairly steady at around MK1,200–1,300/$1 in 2008.

Economic prospects

Recovering from the devastation of Cyclone Nargis is the priority. A plan has been prepared under the auspices of the Tripartite Core Group, comprising the Government of Myanmar, the Association of Southeast Asian Nations, and the United Nations. To be funded by donors, the plan proposes a $690 million recovery program during 2009–2011. By end-2008, commitments to the plan totaled $466 million. The Government is making its own reconstruction arrangements as well, but has not given details.

This spending on reconstruction will contribute to growth. Against that, weaker economic performance in People's Republic of China, India, and Thailand—Myanmar's major trading partners—is likely to put downward pressure on export prices of gas and agricultural products. It is also likely to reduce remittances from Myanmar workers there. On balance, GDP growth is forecast to slow in FY2008 and FY2009. The current account is expected to remain in surplus, supported by the planned inflows of foreign aid.

Myanmar has faced international economic and diplomatic sanctions for much of the past two decades. Immediately after the cyclone, the Government did not allow personnel and aid supplies from international agencies into the country, but later in the year it offered cooperation with the agencies. This engagement opens the possibility that cooperation on aid might be broadened to include areas not directly affected by the cyclone, but where poverty reduction is urgently needed. The Tripartite Core Group may well continue to play a role in managing such assistance.

3.27.1 Development challenges

The agenda of required reforms is extensive. Further liberalization of agriculture, domestic trade, and state enterprises would promote growth and help strengthen the fiscal position, paving the way for an increase in spending on poverty reduction, health, and education.

Development of banking and a domestic bond market would help mitigate the need to monetize deficits—a process that feeds into high inflation—while a unified exchange rate would reduce pricing distortions and strengthen incentives in the economy.

Improvements in the environment for private-sector development would lift investment, including nonenergy sectors, and so stimulate growth and employment. Higher standards of governance and transparency are among the requirements for a better business climate.

Limited by weaknesses in human and financial capacity and institutions, official data generally lack timeliness, reliability, and comparability. Strengthening such resources would allow the authorities greater economic assessment capabilities to serve as a base for enhanced policy making.

Philippines

GDP growth slowed sharply in 2008, largely reflecting the effects of decade-high inflation on consumption and of weakening global demand for exports. The Government has eased fiscal and monetary stances and plans a stimulus package. These moves should mitigate the slowdown caused by a forecast decline in exports and sluggish domestic demand, and help protect the poor. But they will not prevent a slide in growth this year.

Economic performance

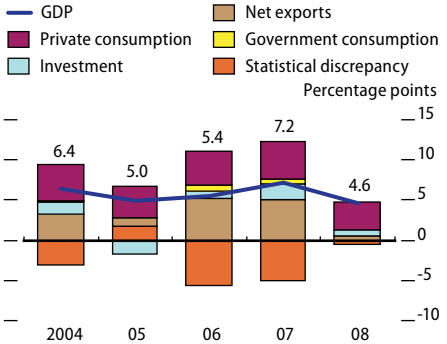
Hampered by a surge in inflation and weaker external demand, GDP growth slowed to 4.6% in 2008 from 7.2% in 2007. Gross national product, which includes remittances from nearly 9 million Filipinos working abroad, decelerated to 6.1% from 8.0% last year. These remittances rose by 13.7% to $16.4 billion last year, or by about 9% in peso terms, helping support consumer spending. However, rising prices for food and fuel squeezed such spending, which accounts for about 77% of aggregate demand, slowing its growth to 4.5%. Still, private consumption contributed most to GDP growth from the demand side (Figure 3.28.1). Growth in government consumption spending also ebbed, partly owing to a high base effect from election spending in 2007.

Fixed capital investment decelerated sharply to 3.7% growth last year, from 11.8% in 2007, mainly because of a slowdown in public construction from the high level seen in the 2007 election year. Investment outlays on durable equipment rose by just 1.7% for the year, and contracted in the fourth quarter. The investment ratio—gross fixed capital formation as a share of GDP—at 14.8% was unchanged from 2007, but down by about 6 percentage points from 21% in the early years of this decade (Figure 3.28.2). Total investment contributed less than 1 percentage point to GDP growth. Net exports made a small contribution only, reflecting weaker global demand.

Services, by far the biggest supply-side contributor to GDP growth (Figure 3.28.3), saw growth pull back to 4.9%, as higher prices for fuel and food damped consumer spending. Communications and domestic trade recorded the slowest growth in over a decade, at the same time as expansion of the finance subsector abated.

As for industry, its growth eased to 5.0% last year. Manufacturing (about 70% of the sector) grew by 4.3%, slightly faster than in 2007, although its expansion faltered in the fourth quarter when external demand shriveled. Food processing stood out in manufacturing with solid growth, but production of export-oriented electrical machinery (including semiconductors) and textiles fell. Private construction maintained double-digit expansion, assisted by housing investments from overseas workers, but public construction activity contracted after rapid growth in

3.28.1 Contributions to growth (demand)



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph, downloaded 2 February 2009.

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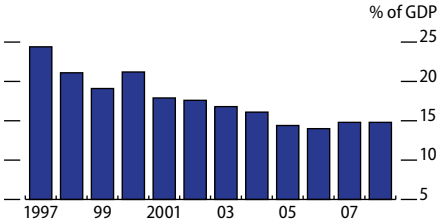
3.28.2 Gross fixed capital formation



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph, downloaded 2 February 2009.

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This chapter was written by Teresa Mendoza of the Philippines Country Office, ADB, Manila.

2007. Mining output was virtually flat, and declining metal prices as the year progressed prompted the deferral of some new mining operations. Agriculture (including fisheries and forestry) grew at a 3-year low of 3.2%, as a result of much higher fertilizer and fuel costs.

Surges in the price of rice and other food (food makes up about half the consumer price index), along with oil, pushed inflation to a peak of 12.4% in August 2008 (Figure 3.28.4). Looking to ensure rice supplies, the Government increased its purchases on the international market in the first half of 2008, when prices were particularly high. Rice has a weight of 9.4% in the consumer price index, so its higher price accounted for 3.7 percentage points of the inflation rate in August. As global commodity prices eased later in 2008, inflation stepped down to 8.0% by December. The year-average rate was still the highest in a decade though, at 9.3%.

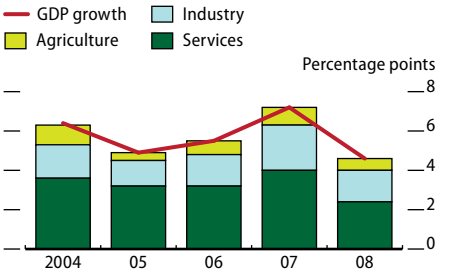
Reflecting the slowdown in external demand, merchandise exports in nominal US dollars fell by 2.6% in 2008 for the first contraction since 2001. In December, as the global downturn deepened, exports plunged by 40.3% year on year (Figure 3.28.5). They declined across all major product categories, with electronic products (about 60% of total merchandise exports) down by 8.3% in 2008 and clothing down by 15.5%. Merchandise imports nudged up by about 5.0%, driven by high world commodity prices for much of the year. The cost of crude oil imports (12.3% of total merchandise imports) shot up by 30.8%, while the cost of rice imports (about 3%) trebled from 2007's level. However, imports of capital goods declined by 4.2%, a sign of the weakness in investment.

These developments propelled the trade deficit to $12.6 billion, from $8.4 billion a year earlier. Inflows of remittances helped keep the current account in surplus, although that surplus fell to $4.2 billion (2.5% of GDP). The surplus in the capital account likewise was sapped by portfolio investment outflows, and inflows of foreign direct investment fell to $1.5 billion. The overall balance-of-payments surplus was $89 million, down from a record $8.6 billion in 2007. This put downward pressure on the peso, which lost 13.0% against the US dollar over the course of 2008.

Gross international reserves rose to $37.6 billion at end-2008, largely on account of government borrowing abroad and a revaluation of gold assets in line with higher world bullion prices. Reserves climbed further by February 2009 to $38.9 billion (6.2 months of import cover and 4.6 times short-term external debt based on original maturity), reflecting proceeds from a government bond issue, loans from multilateral development banks, and privatization of the National Power Transmission Corporation.

After reining in the fiscal deficit over several years, the Government changed tack in 2008 given need to provide more help to vulnerable groups hit by much higher food and fuel prices. Among other assistance, it provided cash transfers to poor families to send their children to school and to pay for electricity, and exempted minimum wage earners from income tax. In addition, the rice subsidies targeted at the poor were much more costly to the budget in 2008, when the price of rice soared. Total government expenditure rose by 10.6% (or 13.3% excluding interest payments). Tax revenue increased by 12.5%, though still below the official target. The Government postponed its goal of achieving a balanced budget

3.28.3 Contributions to growth (supply)



Sources: Asian Development Outlook database; National Statistical Coordination Board, available: http://www.nscb.gov.ph, downloaded 2 February 2009.

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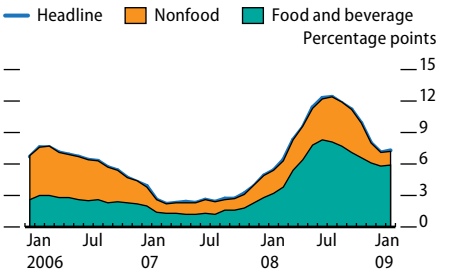
3.28.4 Contributions to inflation



Sources: National Statistics Office, available: http://www.census.gov.ph; CEIC Data Company Ltd., both downloaded 10 March 2009.

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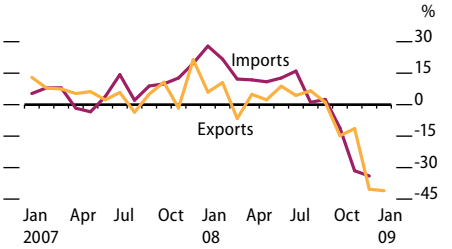
3.28.5 Merchandise trade growth



Note: Based on customs data.

Sources: National Statistics Office, available: http://www.census.gov.ph; CEIC Data Company Ltd., both downloaded 10 March 2009.

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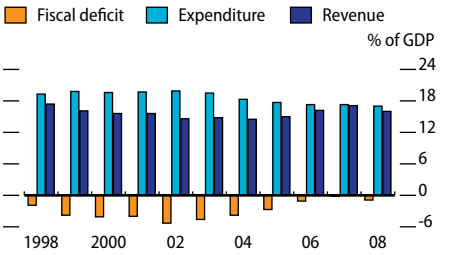
in 2008, instead recording a fiscal deficit of 0.9% of GDP (including about $700 million of privatization receipts as revenue) (Figure 3.28.6).

Leaning against inflation pressures, Bangko Sentral ng Pilipinas hiked its policy interest rates by 100 basis points between June and August 2008. Later, as inflation slowed and global weakness heightened risks to economic growth, it cut the policy rates by 125 basis points from December 2008 to March 2009, bringing its overnight lending rate down to 6.75%. It also lowered commercial bank reserve requirements by 2 percentage points in November and took steps to guard against tight liquidity in the banking system, including liberalizing banks' access to the rediscounting facility. Broad money (M3) growth picked up to 15.6% in December from 10.6% a year earlier.

Job creation remained lackluster—average employment growth slowed to 1.6% in 2008 from 2.8% in 2007. The unemployment rate rose to 7.7% in January this year from 7.4% a year earlier. Underemployment remained at around 18% of the workforce.

3.28.6 Fiscal indicators



Sources: CEIC Data Company Ltd.; Bureau of the Treasury, available: http://www.treasury.gov.ph, both downloaded 3 March 2009.

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Economic prospects

The outlook is for a further deceleration in economic growth in 2009 as global demand weakens for both exports and workers from the Philippines, damping consumption and investment. Projections assume that fiscal and monetary policies remain accommodative, and that there is limited adverse impact on investor sentiment arising from the national and subnational elections scheduled for May 2010.

Consumer spending, though benefiting from the downtrend in inflation, is projected to grow by just 3.0%. That is because remittance inflows will likely flatten in US dollar terms as labor markets weaken worldwide. The number of workers going abroad last year rose until November on a year-on-year basis, but then fell by 5.8% in December (Figure 3.28.7). Furthermore, the domestic labor market is waning as export industries, among others, trim headcounts, alongside the prospect of an influx of unemployed overseas workers. The National Economic and Development Authority, the official development planning body, estimates that about 800,000 workers at home and abroad are vulnerable to losing their jobs.

Against that, higher public spending will support economic growth. The Government in January this year announced plans for a P330 billion ($6.9 billion) economic stimulus package. About 50%, or P160 billion, will come from budget appropriations in 2009 to expand welfare programs, such as cash transfers to poor families as well as labor-intensive infrastructure projects that can be quickly implemented, including road maintenance, reforestation, and classroom building. Another 30%, or P100 billion, is for large infrastructure projects to be funded by government corporations and the social security system.

The stimulus package also includes tax breaks, some of which were in train before the economic slowdown, and which will cost the budget P40 billion. These include an increase in individual taxpayers' personal tax exemptions and a reduction in corporate income tax from 35% to 30%.

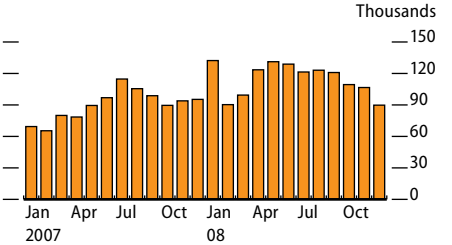
Still, both domestic and foreign private investment is expected to remain sluggish this year because of the weak demand for exports, the

3.28.1 Selected economic indicators (%)

	2009	2010
GDP growth	2.5	3.5
Inflation	4.5	5.0
Current account balance (share of GDP)	1.0	2.0

Source: Staff estimates.

3.28.7 Deployed overseas workers



Source: CEIC Data Company Ltd., downloaded 18 February 2009.

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global credit squeeze, and caution ahead of next year's polls. An index of business confidence for the first quarter of this year fell to its lowest level since 2002. With exports of semiconductors, textiles, and other major products slashed in recent months—total exports dropped by 41.0% in January year on year—the value of total exports is projected to fall by about 15% in full-year 2009. Imports of raw materials and intermediate products used in producing exports will fall in tandem. Weaker consumption, investment, and lower average prices of imported oil and commodities will also curtail imports.

In this context, GDP growth is forecast to slow to 2.5% in 2009 (Figure 3.28.8). It is seen picking up in 2010 to 3.5%, if the global economy and trade both rally late next year as assumed. Accommodative monetary and fiscal policies are expected to contribute to the pickup. The current account is seen retaining small surpluses.

From the production side, industry will be hurt this year by depressed demand for manufactured exports, and private construction by weaker growth in incomes and flattening remittance inflows. This will be somewhat counterbalanced by higher public construction resulting from the lift in government spending. Services, particularly those linked to retail trading and real estate, will be hit by the impact of the slackening labor market on consumption and by the expected zero remittance growth. Financial services are unlikely to expand much at a time of global financial turmoil, given the banks' extra caution.

Inflation is set to moderate to 4.5% on average in 2009, a result of the economic slowdown and lower prices for imported oil and food (Figure 3.28.9). In January and February this year, inflation averaged 7.2%, declining toward levels last seen in the first quarter of 2008. That could pave the way for further easing in monetary policy to support growth.

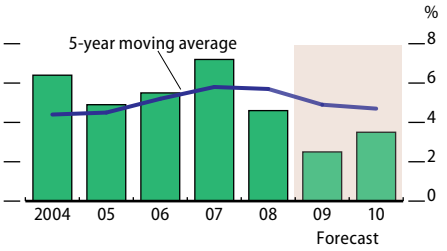
With fiscal spending projected to rise substantially, the budget deficit could widen to about 2.5% of GDP (Figure 3.28.10). Fiscal slippage much beyond this risks unsettling financial markets and rating agencies, raising borrowing costs. In early 2009, Moody's reaffirmed its positive rating outlook, and Fitch and Standard and Poor's their stable outlook, on Philippine sovereign debt.

The agencies underscored the need for the authorities to intensify revenue-raising efforts to support their higher planned spending. This is especially important since revenue will be curtailed this year both by the impact of the economic slowdown on taxes and by the tax breaks provided in the stimulus package.

Amounts raised from the scheduled sale of more state-owned assets will depend partly on the state of financial markets. In January this year, the Government moved quickly to raise $1.5 billion through an issue of 10-year bonds on the international capital market, but it paid a hefty 6 percentage point premium over comparable US Treasuries.

The national government debt has fallen significantly in recent years, from the equivalent of 77.7% of GDP in 2003 to 56.3% in 2008. However, the debt is still high and interest payments absorb a quarter of total expenditure. Moreover, contingent liabilities—mainly guarantees issued by the national Government—add a further $11.2 billion to the debt (Figure 3.28.11). After the Government paid early some external debt in

3.28.8 GDP growth



Sources: Asian Development Outlook database; National Statistical Coordination Board, available:http://www.nscb.gov.ph, downloaded 2 February 2009; staff estimates.

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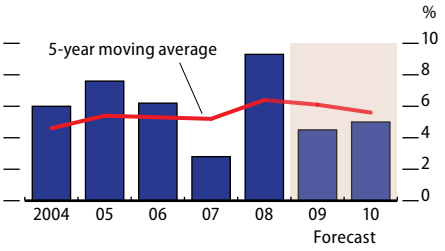
3.28.9 Inflation



Sources: Asian Development Outlook database; National Statistics Office, available: http:www.nso.gov.ph, downloaded 10 March 2009; staff estimates.

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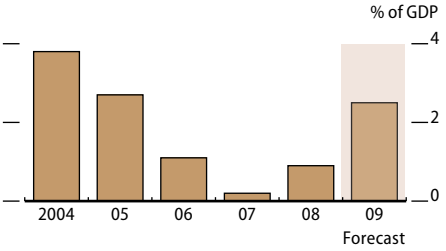
3.28.10 Fiscal deficit



Sources: CEIC Data Company Ltd.; Bureau of the Treasury, available: http://www.treasury.gov.ph, both downloaded 3 March 2009; staff estimates.

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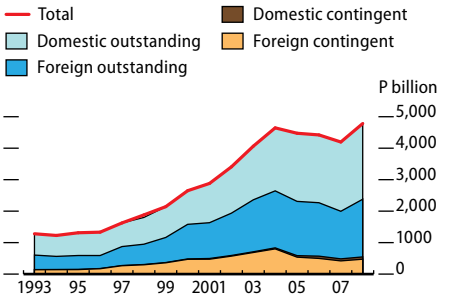
2007, when the peso appreciated, public external debt dropped to about 22.8% of GDP in November 2008 from nearly 50% in 2003.

The Philippine banking sector entered the global financial crisis in a relatively healthy position, with ratios of 15.2% for capital adequacy (end-September 2008) and 3.5% for nonperforming loans (end-December 2008). Its profits will be crimped, though, and loan quality will suffer during the economic slowdown.

Domestic risks to the economic outlook include delayed implementation of the stimulus package due to capacity constraints.

The political risk of disruptions to the 2010 elections cannot be completely ruled out. Also looking to next year, if the global economy does not pick up as assumed, the Government will be hard pressed to fund additional fiscal stimulus measures, given its budget constraints.

3.28.11 National government debt



Sources: CEIC Data Company Ltd.; Bureau of the Treasury, available: http://www.treasury.gov.ph, both downloaded 3 March 2009.

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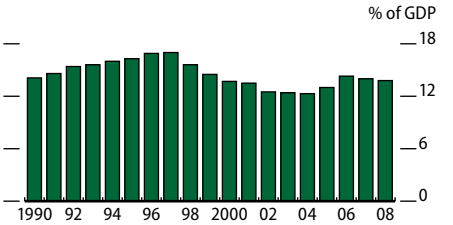
Development challenges

In common with other countries in Southeast Asia, two near-term challenges stand out: safeguarding the achievements of recent years (including stronger growth momentum and progress in fiscal management), and protecting society's most vulnerable groups during the slowdown. Even before the downturn, the incidence of poverty was rising, to 32.9% of the population in 2006 (the latest data available) from 30.0% in 2003, and progress on certain health and education indicators of the Millennium Development Goals was tardy. Social programs to protect the poor sometimes lack funds and often require better targeting.

Still-high debt and the large share of interest payments in the budget expose the economy to swings in financial markets. They also underscore the importance for the Government of containing the debt risk premium through making steady progress on reforms. Further increases in revenue as a share of GDP and reductions in debt would not only reduce vulnerabilities but also build the fiscal resources needed for infrastructure and social programs. Tax revenue as a share of GDP has plateaued at the relatively low level of 14.0% in the past 2 years, after some improvement in 2006 (Figure 3.28.12).

Perennial causes of poverty include a high population growth rate and lack of job opportunities in the country. Deployment of large numbers of workers overseas masks the extent of domestic unemployment. Greater employment generation requires increased investment, but this is unlikely without improvements in the business climate. The 2008–2009 *Global Competitiveness Report* of the World Economic Forum ranks the Philippines 71 out of 134 countries and identifies inefficient government bureaucracy, inadequate infrastructure, policy instability, and corruption as important constraints.

3.28.12 Tax revenue



Sources: CEIC Data Company Ltd.; Bureau of the Treasury, available: http://www.treasury.gov.ph, both downloaded 3 March 2009.

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Singapore

Moving closely in line with the global business cycle, growth decelerated during 2008 on a year-on-year basis and contracted in the fourth quarter. The economy is forecast to shrink this year, before bouncing back next year. A significant fiscal stimulus package will help cushion the severity of the recession, although in the highly open economy much of the stimulus will leak abroad. Cushioning externally induced macroeconomic volatility is a particularly difficult challenge in a city-state.

Economic performance

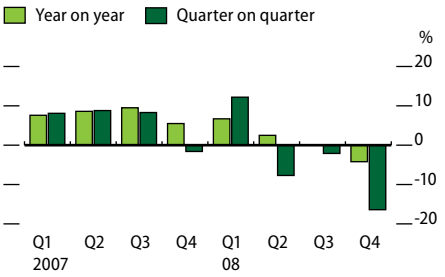
The global downturn hit this exceptionally open economy with full force during 2008. GDP growth was just 1.1%, far short of the 5-year average of 7.3% in 2003–2007 and the slowest since 2001, when GDP contracted during the global information technology slump. Reflecting the high correlation between the global business cycle and Singapore's economic performance, GDP growth slowed from 6.7% in the first quarter, year on year, until the economy contracted by 4.2% in the fourth (Figure 3.29.1). On a quarter-on-quarter basis, output declined from the second to fourth quarters of 2008.

The net export slump caused by the global slowdown acted as a serious drag on GDP growth, which was driven entirely by domestic demand. In particular, construction investment in the public sector played a key role in boosting domestic demand.

The impact of the global downturn was most evident in international trade, which fell by 11.6% in nominal US dollar terms (5.6% in volume terms) in the fourth quarter. Given Singapore's role as a trade hub that supports trade-related services from transportation to trade finance, the slowdown of trade had ramifications far beyond the export-oriented manufacturing sector. This helps explain why Singapore has been among the hardest hit economies. Another factor that has magnified the impact of the global slump is the economy's shift into higher value-added industries, such as biomedical manufacturing. The upgrading helps diversify the industrial base, but also increases dependence on demand from those industrial countries at the center of the global crisis. Total exports fell by 13.9% in the fourth quarter (Figure 3.29.2), although growth in the first 3 quarters, buoyed by high oil prices that raised prices of petroleum exports, allowed for growth of about 13% for the whole year.

Non-oil domestic exports fell by 19.6% in the fourth quarter, and by 1.9% for the year. External demand weakened in 2008 relative to 2007 for integrated circuits, consumer electronics, telecommunications equipment, and personal computers, as well as for pharmaceuticals, petrochemicals, and primary chemicals. Demand for non-oil exports weakened most notably from the United States (US) and Europe. Petroleum exports fell late in the year but rose for the full year by more than 50%. In volume terms, oil exports expanded by 15.5%.

3.29.1 Quarterly GDP growth



Source: Singapore Ministry of Trade and Industry, *Economic Survey of Singapore 2008*.

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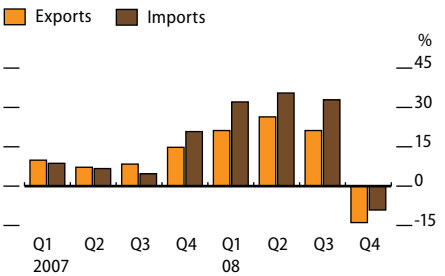
3.29.2 Merchandise trade growth



Source: CEIC Data Company Ltd., downloaded 14 March 2009.

Click here for figure data

This chapter was written by Donghyun Park of the Economics and Research Department, ADB, Manila.

In the context of domestic demand, robust investment more than offset faltering consumption. Private consumption growth slowed to 2.4% in 2008, less than half the rate of 2007 (Figure 3.29.3). Consumption contracted in the fourth quarter. Deteriorating labor market conditions have led to concerns over job security and an erosion of consumer confidence. Further denting consumer confidence has been the year-long rout of the stock market. Higher government consumption bolstered overall consumption growth to 3.6%.

Both private and public investment grew at a healthy pace—14% and 13%, respectively. However, private investment contracted by 13% in the fourth quarter as business confidence plummeted in reaction to the fast-deteriorating global outlook. The growth in investment was largely driven by an upturn in construction, which overshadowed generally feeble equipment investment.

From the output perspective, business services, construction, and financial services were the biggest contributors to GDP growth in 2008 (Figure 3.29.4). Construction roared ahead by 20%, while business services and financial services expanded by 7.4% and 5.5%. For the year as a whole, all sectors except manufacturing made positive contributions to GDP growth. However, the financial services industry contracted by 8.1% in the fourth quarter, due to the global financial crisis and the economic slowdown. Trading activities fell substantially in foreign exchange, stock brokerage, and fund management. The fourth quarter also witnessed the contraction of wholesale and retail trade as well as transport and storage, largely as a result of declining world trade volumes.

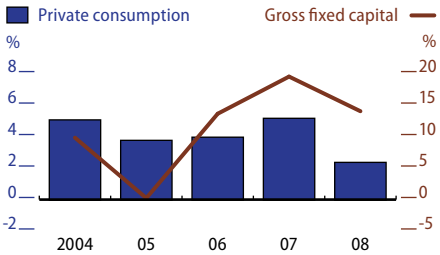
Manufacturing suffered the biggest contraction, for both the fourth quarter (down 10.7%) and the entire year (down 4.1%). The manufacturing slump was driven by weakening global demand, and was most evident in the electronics and biomedical industries.

Inflation surged to 6.5% in 2008, from 2.1% in the previous year and 1.1% on average in 2003–2007. The surge was sparked by higher global oil and food prices during the first 3 quarters, and inflation eased by late 2008.

Of greater concern was the deterioration of the labor market in line with the worsening economic outlook. Employment rose by about 27,000 in the fourth quarter, less than half the 56,000 growth in the third, and although for the whole year employment increased by a healthy 227,000, most of the gain came in the first half. The number of layoffs, which climbed to 13,400 in 2008 from 7,700 in 2007, also rose sharply in the final quarter.

In the external accounts, lower surpluses were recorded in both goods and services trade. The current account remained in substantial surplus, equivalent to 14.8% of GDP. Gross international reserves rose to $174.2 billion.

3.29.3 Consumption and investment growth



Sources: Singapore Department of Statistics, available: http://www.singstat.gov.sg/; CEIC Data Company Ltd., both downloaded 10 March 2009.

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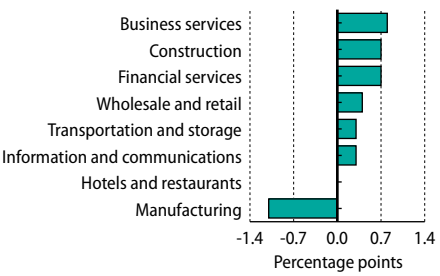
3.29.4 Contributions to growth (supply), 2008



Source: Singapore Ministry of Trade and Industry, *Economic Survey of Singapore 2008*.

Click here for figure data

Economic prospects

Structural and strategic dependence on external demand has served Singapore well over the past four decades, transforming it into one of the richest economies. The downside of an exceptionally high degree of globalization is that the economy is hit disproportionately hard when the world trade and growth turn down. Singapore has higher trade

dependence than other Asian economies and this gap has increased in recent years (Figure 3.29.5). A wide range of its services, too, depend on trade. Further, as a financial center, it will suffer more than most economies from the global financial crisis and cuts in staffing at banks and brokerages. Moreover, it is a subregional headquarters for multinational companies, many of which are trimming operations. Irrespective of the uncertainty surrounding the global outlook for this year, this economy is seen contracting substantially in 2009.

The downward momentum of late 2008 has continued into 2009. Exports fell by 40% in January and imports by 36%, year on year. The slide in exports was across the board in terms both of product groups and export markets. Manufacturing output declined by 29.1% on a year-on-year basis in January.

Private domestic demand is unlikely to provide much relief from the slump in external trade. Uncertainty surrounding the economy is likely to intensify during the first half of 2009, and this will induce households to save rather than spend. Job market conditions are expected to worsen before they get better. As a result, private consumption is set to contract in the first half. The weakening in trade and manufacturing bodes ill for equipment investment, which is likely to contract during the first half. The one area of private domestic demand that remained robust in 2008—construction investment—is likely to weaken in 2009 in response to a stagnant housing market (Figure 3.29.6). Any significant boost to domestic demand will have to come from the Government.

In response to this bleak outlook for 2009, the Government announced an unprecedented expansionary budget in January, with total spending set at S$43.6 billion (US$29.3 billion). The primary operating fiscal balance is set to be in deficit equivalent to 10.2% of GDP for FY2009 starting 1 April 2009, (compared with a surplus estimated at 1.6% of GDP in FY2008).

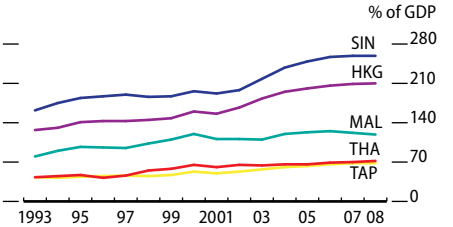
The centerpiece is a stimulus package costing S$20.5 billion. Two notable components are the S$4.5 billion Jobs Credit Scheme (Box 3.29.1) and a Special Risk-Sharing Initiative, which gives individual firms access to working capital of up to S$5 million, with the Government bearing 80% of the default risk associated with those loans. The Government has also cut the corporate income tax rate from 18% to 17%, and provided personal income tax rebates of 20%, capped at S$2,000. The Government plans to use S$4.9 billion from its hefty fiscal reserves, obviating the need to borrow.

Although the large size of the stimulus will inevitably have some positive growth effects, it will at most limit the severity of the recession. The fiscal stimulus will also strengthen social safety nets and protect the most vulnerable groups. For example, workers on the Workfare program, which gives cash grants to low-income working households, will get 50% more in transfer payments to help them cope with the economic downturn.

The Monetary Authority of Singapore in October 2008 in effect loosened monetary policy when it changed its 3-year-old policy of allowing a "modest and gradual" appreciation of the Singapore dollar against a trade-weighted basket of foreign currencies to a target of zero appreciation.

Given the likely trajectory of the global business cycle, the economy is expected to shrink by about 8% in the first half of 2009, year on year, and by about 2% in the second. For the year as a whole, GDP growth is projected to contract by 5.0%, marking the weakest performance since

3.29.5 Exports of goods and services



HKG = Hong Kong, China; MAL = Malaysia; SIN = Singapore; TAP = Taipei,China; THA = Thailand.

Source: CEIC Data Company Ltd., downloaded 12 March 2009.

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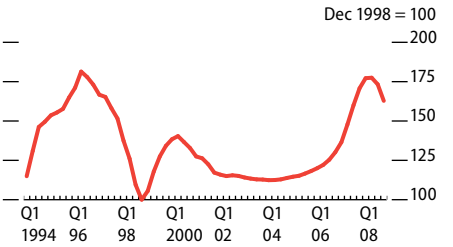
3.29.6 Private residential property price index



Source: CEIC Data Company Ltd., downloaded 12 March 2009.

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3.29.1 Selected economic indicators (%)

	2009	2010
GDP growth	-5.0	3.5
Inflation	0.5	2.0
Current account balance (share of GDP)	10.0	14.0

Source: Staff estimates.

3.29.1 Jobs Credit Scheme

The Jobs Credit Scheme aims to prevent mass layoffs by offering cash grants to employers to cover part of their wage bill. The cash grant is equivalent to 12% of the first S$2,500 (i.e. up to S$300) of the wages of each employee who contributes to the Central Provident Fund (CPF), the national savings plan. CPF criteria limit Jobs Credit benefits to Singaporean citizens and permanent residents. In effect, it is a temporary wage subsidy to employers that gives them an incentive to retain workers, with the subsidy amounting to a 9% cut in the employer's contribution rate to the CPF.

Anecdotal evidence indicates that the savings and additional cash flow from the Jobs Credit Scheme are quite significant, especially for labor-intensive firms, and is helping to save some jobs (*Singapore Market Weekly* 2009). A more formal empirical analysis using a macroeconomic model found that the program could save up to 30,000 jobs in 2009, and 50,000 each in 2010 and 2011 (Abeysinghe and Gu 2009). Absent the scheme, the GDP contraction and the downward inertia of wages would lead to larger job losses over a longer period. However, it is possible that the scheme may merely transfer resources to those companies that would have kept workers anyway, without having much impact on the employment decisions of struggling enterprises.

The burden of adjustment during recessions in the past has largely fallen on workers, in the form of a cut in the employer's contribution rate to the CPF. Under the Jobs Credit Scheme, that burden is transferred to the Government.

References

Abeysinghe, T. and J. Gu. 2009. "Jobs Credit Scheme—Measuring its effectiveness." *Straits Times*, 16 February 2009.

Singapore Market Weekly. 2009. "Call It A (Deeper) Recession." 2 March 2009.

independence in 1965. Growth is expected to resume at about 3.5% in 2010 (Figure 3.29.7), on the back of global and regional recovery.

Both upside and downside risks are those associated with the depth and length of the global downturn. The downside risks overshadow those on the upside at the moment, which suggests that a contraction more severe than 5.0% this year is more probable than one less severe. Inflation will fall sharply to average 0.5% this year, due to the recession and weak commodity prices. The current account surplus is projected to decline to about 10.0% of GDP as a result of export compression, before it rises again in 2010.

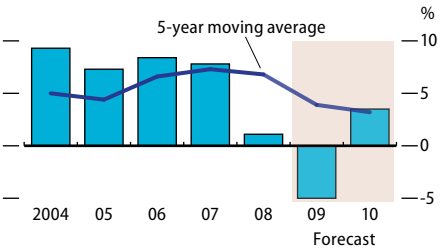
Development challenges

The high import content of goods in this highly open economy and the consequent leakages of fiscal stimulus to other economies constrain the countercyclical impact of fiscal policy. However, strengthening social safety nets and protecting the most vulnerable groups are worthy objectives in themselves. The Government has recently accorded a higher priority to those objectives and it has taken some concrete steps, including the increased transfer payments in the Workfare program.

The deep contraction in this city-state of 4.8 million people brings into sharper focus the lack of a domestic demand base that could cushion the effect of an external shock such as the current one. In this regard, there has been a remarkable reduction in the ratio of private consumption to GDP in recent years. Strong growth of exports can partly account for this drop. However, the share of consumption has been more or less stable, at a far higher level, in Hong Kong, China, a comparable economy (Figure 3.29.8).

A more structural explanation is that high levels of home ownership in Singapore and correspondingly high levels of financial liabilities have suppressed disposable incomes and hence consumption. One possible policy option is to open up more avenues for households, especially older households, to convert their housing wealth into purchasing power.

3.29.7 GDP growth



Sources: Singapore Department of Statistics, available: http://www.singstat.gov.sg; CEIC Data Company Ltd., both downloaded 10 March 2009.

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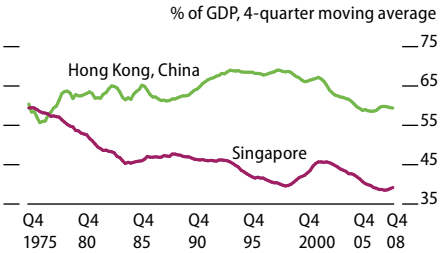
3.29.8 Private consumption expenditure



Source: CEIC Data Company Ltd., downloaded 12 March 2009.

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Thailand

Political disruptions undermined the economy in 2008, hurting government expenditure and private investment. Allied to the onset of the global economic slowdown, which punished exports in the fourth quarter, they slowed economic growth to the worst outturn since 2001. Inflation accelerated in the first half, then fell back. The economy is expected to contract in 2009. Expansionary monetary and fiscal policies will help to a degree, but the Government may well need to do more to ensure that growth is sustained after its expected resumption next year.

Economic performance

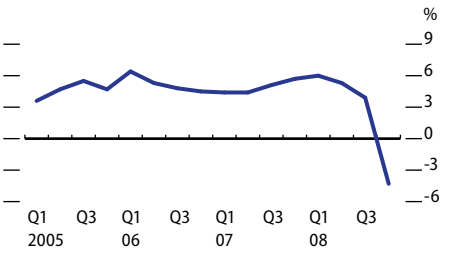
The impact of political disruptions and the global economic slowdown cut economic growth to 2.6% in 2008, about half the 2007 rate and the slowest since 2001. After 6 months of solid growth approaching 6% on a year-on-year basis, the economy braked in the third quarter then contracted by 4.3% in the fourth (Figure 3.30.1) when the global slowdown slashed exports. Over the year, weakness in government expenditure, private investment, and exports sapped growth.

A contraction of public expenditure stemmed from political tensions and associated policy uncertainties. Antigovernment protestors disrupted transportation and sparked clashes that led the Government to declare a state of emergency in Bangkok for 12 days in September. Tensions worsened when the protestors took control of Bangkok's two main airports, which were shut down for 9 days from 24 November. In December, the Constitutional Court disbanded the three main parties in the governing coalition, requiring the formation of a new government. Indeed, Thailand had four prime ministers during 2008. The frequent changes caused delays in budget disbursement and in the implementation of government projects, including mass rapid transit projects proposed since 2007 for Bangkok. Public investment contracted by 4.8% in 2008, compared with 3.4% expansion in 2007, and public consumption grew only by 0.4% (down from 9.1% in 2007).

As the global slowdown deepened, exports of goods and services contracted by 8.7% in the fourth quarter of 2008, after strong growth in the first 3 periods. Services exports grew by just 3.2% in full-year 2008, less than half the rate of the previous year. Tourist arrivals fell by 1.3%, reflecting the domestic political turmoil and closure of the Bangkok airports, as well as a decline in tourists from the major industrial markets, which were sliding into recession.

Goods exports in real terms fell by 9.0% in the fourth quarter, a result of the slump in global demand and the closure of the airports. Exports of machinery and transport equipment were hit hardest, followed by labor-intensive and resource-based products. However, because of solid

3.30.1 Quarterly GDP growth



Source: National Economic and Social Development Board, available: http://www.nesdb.go.th, downloaded 16 March 2009.

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This chapter was written by Luxmon Attapich of the Thailand Resident Mission, ADB, Bangkok.

expansion of goods exports in the first half of 2008, notably rice, cassava, and computers, real merchandise exports decelerated only a little to 6.0% in the whole year, from 6.7% in 2007.

Imports of goods and services also declined in the fourth quarter, in response to the weakness in domestic demand. Earlier, industry had increased imports of materials such as metal products and chemicals in anticipation of continued economic growth. Thus real imports for the full year rose by 7.5%, despite the decline in the fourth quarter. A contraction in net exports subtracted 0.2 percentage points from GDP growth (Figure 3.30.2), in contrast to 2007 when net exports were the source of most of that year's expansion.

Private investment growth declined steadily from the second quarter of 2008, contracting by 1.3% year on year in the fourth. The political uncertainty as well as the slowdowns in the domestic and international economies eroded business confidence. However, strong first-half growth in construction of housing and commercial buildings, mainly in the Bangkok area, contributed to full-year growth in private investment of 3.2%, up from 0.6% in 2007. Investment contributed more than half the total GDP growth.

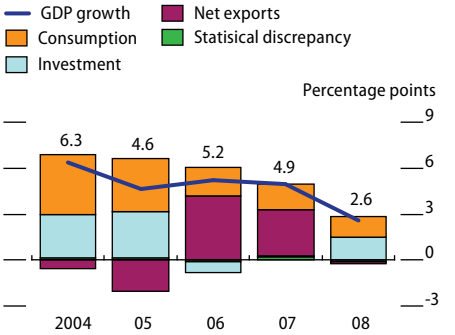
In contrast to other GDP components, private consumption expanded in the fourth quarter, and rose by 2.5% for the whole year, picking up from weak 1.6% growth in 2007, despite the slowing economy and slumping stock market. The stock market index fell by 48% in 2008 (Figure 3.30.3). The increase in consumption was most notable in durable goods such as cars, motorcycles, and electrical appliances. In the second half of the year, slowing inflation and expansionary monetary policy supported consumption spending. Bank credit for personal consumption remained buoyant last year, in contrast to bank credit for industry.

On the supply side, only agriculture posted strong growth in 2008, of 5.1%, up from 1.8% in 2007 (Figure 3.30.4). This improvement was partly due to farmers' response to high prices for agricultural products in the first half. Output of rice, palm oil, rubber, and cassava shot up. Growth of manufacturing, however, slowed to 3.9% from 6.2%, with a significant deceleration in the second half as business confidence and export orders dwindled. Electronics, petrochemicals, and leather goods slowed the most. Services decelerated to only 1.2% growth, from 4.7%, mainly a result of the political turmoil and weakness in tourism. Hotels and restaurants, transport, storage and communications, and wholesale and retail trade came off steeply in the second half.

In the external accounts, the second-half decline of merchandise exports cut the full-year trade surplus to $237 million, a small fraction of the previous year's $11.6 billion. The services, income, and transfers accounts registered a combined deficit of $416 million, in part reflecting the reduction in tourism receipts. The current account turned from a surplus in 2007 to a small deficit (0.1% of GDP) in 2008. After accounting for inflows of foreign direct investment in the first half of the year and in spite of net outflows of portfolio investment (because of the global financial crisis and a slump in domestic stock prices), in the second half, foreign exchange reserves rose by 27.5% to $108.3 billion at end-2008 (Figure 3.30.5), equivalent to almost 9 months of imports.

Domestic financial institutions had little direct exposure to assets

3.30.2 Contributions to growth (demand)



Source: National Economic and Social Development Board, available: http://www.nesdb.go.th, downloaded 28 February 2009.

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3.30.3 SET index

Source: CEIC Data Company Ltd., downloaded 16 March 2009.

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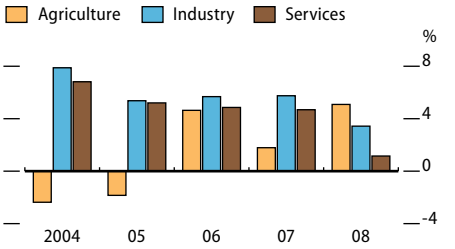
3.30.4 GDP growth by sector



Source: National Economic and Social Development Board, available: http://www.nesdb.go.th, downloaded 28 February 2009.

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of troubled financial institutions abroad. Such "toxic" assets constituted under 0.5% of their total assets. In addition, the blanket guarantee on bank deposits in force since 1997 was extended to 2011, thereby helping maintain confidence in banks. Key indicators, such as the bank capital-adequacy ratio (15.3% in September 2008) and gross nonperforming loans to total loans (5.3% in December 2008), imply that the overall health of banks is sound. Still, the domestic economic slowdown is likely to have some impact on credit quality, and banks have become more hesitant on lending.

Inflation quickened to an 11-year peak at 9.2% in July (Figure 3.30.6), driven by rising global oil and food prices. After core inflation (excluding fresh food and energy) exceeded the Bank of Thailand's target in July, the central bank raised its policy interest rate (the 1-day repo rate) by 25 basis points in both July and August, to 3.75%. Inflation slowed sharply to 2.8% by December, mainly owing to the retreat of global oil and food prices and the slowdown in domestic demand. The Bank of Thailand switched its policy stance and aggressively cut its policy rate in three steps between December and February 2009, to 1.5% (Figure 3.30.7). Average inflation in 2008 at 5.5% was more than double 2007's rate.

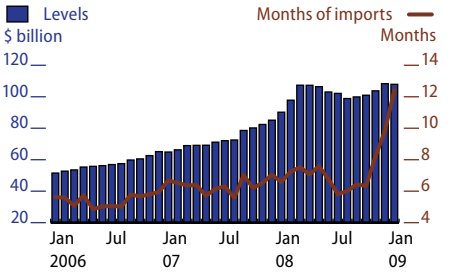
Fiscal policy was generally tight in FY2008 (ended 30 September 2008). Revenue collection increased by 7.3% and exceeded the target. Several fiscal measures were rolled out to stimulate growth, including tax breaks for individuals and small and medium-sized firms as well as funding for community development projects. However, actual disbursement of total budgeted expenditure was lower than in FY2007, mainly due to lack of continuity caused by the frequent changes in administration. The overall fiscal deficit narrowed to 0.3% of GDP, from 1.1% in the previous fiscal year.

Economic prospects

The projections assume that the Government that took office in December 2008 remains in power through the forecast period and that fiscal and monetary policies are expansionary. In January 2009, the cabinet approved a B116.7 billion ($3.4 billion) economic stimulus package aimed at stemming the economic decline. For households, it includes cash transfers for low-income people, training programs for the unemployed, and expanded free schooling and public health services. The Government also extended concessions introduced last year that cover free electricity and water supply for poor households and subsidized public transportation. For businesses, the stimulus package provides low-interest loans for tourism-oriented small firms and funding for small rural enterprises.

The cabinet also approved B40 billion in tax cuts, targeted mainly at small businesses, the tourism industry, and the property market and a B200 billion short-term credit facility for state enterprises. To bolster farm incomes, the Government will guarantee price support for major crops. As for the program of large infrastructure projects prepared several years ago, the Government intends to focus on extending mass transit rail lines in Bangkok. Work is scheduled to start on one line in the first half of this year and on another in the second half.

3.30.5 Foreign exchange reserves



Source: Bank of Thailand, available: http://www.bot.or.th, downloaded 16 March 2009.

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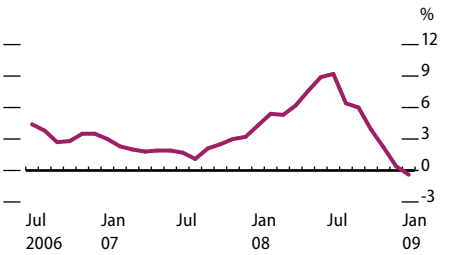
3.30.6 Monthly inflation



Source: Bureau of Trade and Economic Indices, available: http://www.price.moc.go.th, downloaded 16 March 2009.

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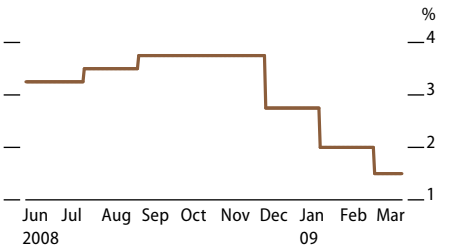
3.30.7 Policy rate



Sources: Bloomberg, downloaded 16 March 2009.

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The sizeable fiscal stimulus including increases in public investment will bolster the economy, albeit it will not ensure growth. The budget deficit, to be funded by both domestic and external financing, is projected to widen to about 5% of GDP in FY2009. In the October–December fiscal quarter, however, disbursements lagged the target, mainly because the new Government continued to face political disruptions, while revenue collections fell short of target. For FY2010, the Government has approved a deficit of about 4% of GDP.

Private consumption is forecast to grow, supported by low inflation and the various measures to assist households through the economic slowdown. However, its growth will slow from 2008, undermined by low consumer confidence (Figure 3.30.8), a rapidly weakening labor market, declines in stock and property prices, and lower farm incomes, despite the price support.

In contrast to private consumption, private investment is projected to contract in the face of weak domestic and external demand and of deteriorating business sentiment. Industrial capacity utilization declined to just 57.1% in January 2009 (Figure 3.30.9), reducing the need to expand production facilities. Moreover, although the central bank has lowered its policy interest rate, banks have become more cautious in lending as a result of the global financial crisis and the erosion of corporate profits induced by the domestic economic slowdown.

Once these strings are drawn together, GDP growth in 2009 is projected to contract by about 2.0%, the first shrinkage since the 10.5% of 1998, which was caused by the Asian financial crisis. As a result, the number of unemployed could rise to almost 2 million in 2009. Growth is seen resuming in 2010, at about 3.0% (Figure 3.30.10), if the global economy revives as assumed. By then, the Government is also expected to have more public investment projects under way.

On the supply side, industrial production is expected to contract, given the poor export outlook and weak domestic demand. Construction will be damped by the low business and consumer confidence and the more circumspect bank lending. Services will suffer from a fall in tourist arrivals and subdued consumer spending. Agricultural production is likely to increase, but less robustly than in 2008, reflecting softer prices for agricultural commodities.

Merchandise exports dropped by 25.3% in January 2009 and by 11.3% in February from the previous year. Merchandise imports plunged by 36.5% in January and by 40.3% in February (Figure 3.30.11). For the year, merchandise exports are forecast to fall by about 18.0%. Merchandise imports will drop by a steep 28.0%, suppressed by weak domestic demand and reduced needs for inputs to the export industries. The trade balance is expected to record a large surplus of $18.0 billion in 2009. The current account is forecast to post a surplus of 8.0% of GDP this year and 4.5% in 2010.

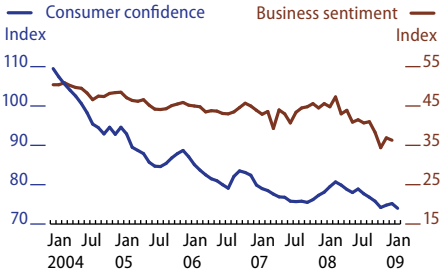
The consumer price index fell by 0.3% in the first 2 months of 2009 from a year earlier, mainly owing to a decline in gasoline prices and charges for electricity and water. (Core inflation rose by 1.7% in that period.) The Bank of Thailand, when it cut the policy rate in February, cited a need to "safeguard price stability," as well as to support the economy. For all 2009, inflation is expected to average just 0.5%

3.30.1 Selected economic indicators (%)

	2009	2010
GDP growth	-2.0	3.0
Inflation	0.5	1.5
Current account balance (share of GDP)	8.0	4.5

Source: Staff estimates.

3.30.8 Consumer and business attitudes



Note: A reading of less than 100 for consumer confidence and less than 50 for business sentiment denotes a deterioration.

Source: Center for Economic and Business Forecasting, Bank of Thailand, available: http://www.bot.or.th, downloaded 16 March 2009.

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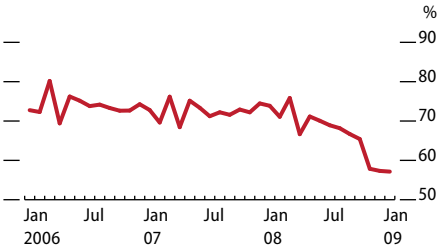
3.30.9 Industrial capacity utilization rate



Source: Bank of Thailand, available: http://www.bot.or.th, downloaded 6 March 2009.

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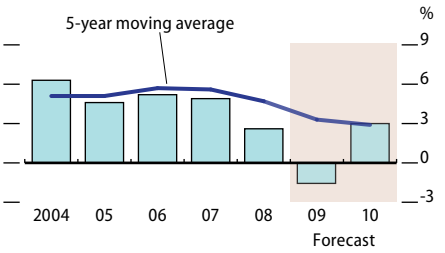
3.30.10 GDP growth



Sources: National Economic and Social Development Board, available: http://www.nesdb.go.th, downloaded 16 March 2009; staff estimates.

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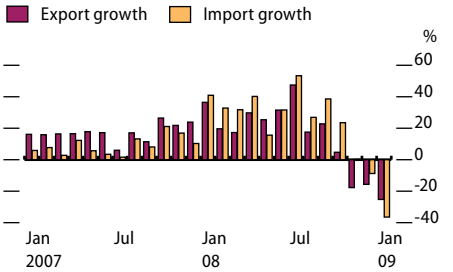
(Figure 3.30.12). It will be kept down by lower global oil and commodity prices relative to 2008 and by weak domestic demand, which will undermine the ability of producers to raise prices of goods and services. The price index is expected to record year-on-year falls in some months of 2009. In 2010, inflation is seen picking up to 1.5%, in line with the expected economic recovery.

The forecasts are subject to two key downside risks. A more prolonged recession in major trading partners would lower exports of goods and services by more than expected. That would further weaken domestic demand and take GDP below the baseline projection. Political uncertainty is another risk, and that could delay the crucial boost in public spending, and thus seriously affect recovery prospects.

3.30.11 Monthly trade indicators



Note: Data are on a customs basis.

Source: Bank of Thailand, available: http://www.bot.or.th, downloaded 16 March 2009.

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Development challenges

The key near-term challenge is to implement the stimulus package effectively to support growth. That requires the Government to improve the disbursement rate of planned expenditure. It also needs to accelerate the rollout of public infrastructure projects, which has fallen behind schedule during the past 3 years of political turbulence.

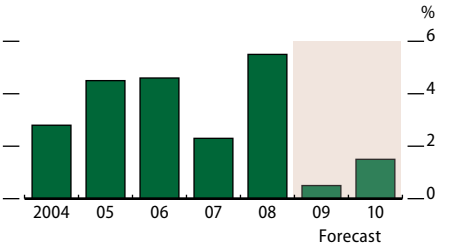
A World Bank investment climate assessment of Thailand in August 2008 found that development of the private sector is hampered by deficient infrastructure, as well as a heavy regulatory burden and shortage of skills. Investment in public infrastructure is needed to maintain the economy's competitiveness in the longer term. Greater private sector participation in infrastructure could be achieved by reforms in the regulatory environment to encourage public-private partnerships. This would reduce the pressure on the budget and free up fiscal resources to address significant shortcomings in education and skills development.

The ratio of public debt to GDP is projected to rise to 43% in 2009. But there still is scope for substantial borrowing for public investment, even in the context of the Government's own self-imposed public debt limit of 50% of GDP. Moreover, foreign exchange reserves are high and external debt has declined steadily to about 24% of GDP.

If the global economic rebound is feeble, the Government might need to consider running significant fiscal deficits for a few years, possibly breaching the self-imposed debt limit in order to support growth. The deficit and debt would then need to be pared back quickly when economic growth is demonstrably sustained.

Thailand could face two other main challenges, depending on the duration of the global slowdown. First, coping with relatively high unemployment for a prolonged period could test policymakers, and social stability. There is a need to consider expanding social safety nets both as a short-term response and over the longer term. Second, while the financial system is sound, a prolonged economic slowdown could lead to a significant rise in nonperforming loans.

3.30.12 Inflation



Sources: Bureau of Trade and Economic Indices, available: http://www.price.moc.go.th, downloaded 16 March 2009; staff estimates.

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Viet Nam

The economy had a turbulent year in 2008. Inflation and the trade deficit surged, and then reversed course. Economic growth slowed and is forecast to moderate further this year, before starting to pick up in 2010. Inflation is projected to be relatively low both years. The current account deficit is expected to widen in 2009 and narrow in 2010. The main near-term challenge is to limit the slowdown in growth while keeping the fiscal and current account deficits in check. In the medium term, the Government needs to ratchet up growth without fueling inflation or widening the current account deficit.

Economic performance

GDP growth decelerated to 6.2% in 2008, down from more than 8% in the preceding 3 years (Figure 3.31.1). Available indirect data suggest that growth of consumption slackened, and that an upturn in foreign-financed investment was offset by a downturn in domestically financed investment. Consumption and domestically financed investment were adversely affected by a volatile and uncertain economic environment, stabilization measures taken by the Government in the first half of the year, and the slowdown of economic activity. Falling stock prices and a cooling real estate market were contributing factors. Year-on-year growth of GDP decelerated from 6.5% in the first 3 quarters of 2008 to less than 6% in the fourth, as the external environment worsened severely.

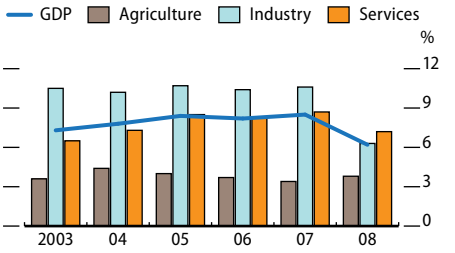
A continued decline in oil production contributed to the slowdown of growth. Total output of crude oil fell to 14.9 million metric tons in 2008 from 15.9 million in 2007. Several new oil fields came on stream in late 2008, but this did not compensate for the decline of output at some old fields.

Month-on-month inflation soared in late 2007 and stayed above 2% in January–May 2008 (Figure 3.31.2). Macroeconomic imbalances, which had built up over several years and manifested themselves in strong inflation pressures and a persistent current account deficit, were exacerbated by domestic supply-side shocks (including poultry and pig epidemics) in late 2007 and early 2008. The rise in world commodity prices contributed to high inflation.

In June–December 2008, month-on-month inflation fell sharply. This reflected the effects of government anti-inflation measures in the first half and the drop in world commodity prices in the second. Month-on-month inflation picked up slightly in January–February 2009 on account of seasonal factors, but was much lower than a year earlier. Year-on-year inflation rose to 28.3% in August 2008, but pulled back to 14.8% in February 2009. Still, the annual average inflation rate, at 23.0% in 2008, was the highest since 1992.

To curb inflation, the State Bank of Viet Nam (SBV), the central bank,

3.31.1 GDP growth by sector



Source: General Statistics Office of Viet Nam.

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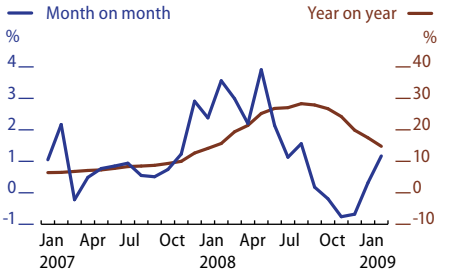
3.31.2 Inflation



Source: General Statistics Office of Viet Nam.

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This chapter was written by Bahodir Ganiev of the Viet Nam Resident Mission, ADB, Hanoi.

tightened monetary policy significantly in the first half of 2008. Notably, it raised banks' reserve-requirement ratios, issued central bank bills that commercial banks were required to buy, and raised policy interest rates (Figure 3.31.3). SBV lifted the base rate to 14.0% in June 2008 from 8.25% at the start of the year. (There is a ceiling on bank lending rates equal to 1.5 times the base rate.) Consequently, growth of credit and money supply slowed (Figure 3.31.4).

With inflation down sharply and growth decelerating, SBV eased monetary policy quickly in the fourth quarter of 2008 (and in early 2009). In particular, it reduced the reserve-requirement ratios and lowered policy rates (cutting the base rate to 7.0% by February this year). However, these measures did not lead to commensurate increases in credit and money supply because banks had become more cautious in lending and hoarded liquidity. Growth of credit and money supply continued to slow in the second half of 2008.

As part of its efforts to reduce inflation and the trade deficit, in the first 6 months of 2008 the Government tightened fiscal policy and control over investment by state enterprises. Many public investment projects, including those of state enterprises, were suspended, postponed, or canceled. The budget recorded relatively small deficits in the first 3 quarters (Figure 3.31.5).

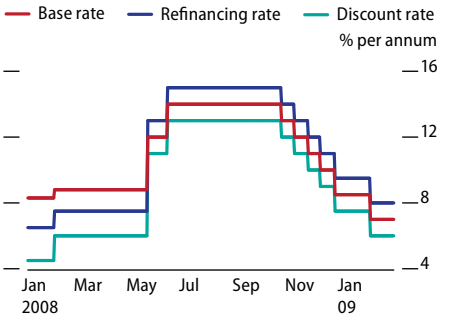
The Government began to loosen fiscal policy toward the end of the year, in order to mitigate the impact on growth of the global financial crisis and economic downturn. The fiscal deficit swelled in the fourth quarter, but over the year it narrowed to an estimated 4.7% of GDP, from 5.5% in 2007.

In early December 2008, the Government announced that it would adopt a fiscal stimulus package of about $1 billion. It later indicated that the size of the package could increase to $6 billion. During January–February this year, the Government approved several fiscal stimulus measures. In particular, it reduced by 30% corporate income tax rates for small and medium-sized enterprises for the fourth quarter of 2008 and for 2009, and cut by half the value-added tax on certain goods and services until end-2009. It also decided to give one-time additional financial assistance to poor households, and to firms a 4 percentage point interest rate subsidy on their short-term (up to 8 months) bank loans contracted and disbursed in February–December this year.

During 2008, Viet Nam maintained a de facto crawling peg exchange rate regime with a trading band in relation to the US dollar, but widened the band from 0.75% to 3.0% around SBV's reference exchange rate (Figure 3.31.6). Several times during the year the formal foreign exchange market did not clear at a rate within the trading band and the black market exchange rate moved outside the band. Most notably, a severe shortage of foreign exchange emerged in the formal market and the black market exchange rate depreciated sharply in June 2008, when expectations of persistent high inflation and a balance-of-payments crisis triggered capital flight and engendered strong downward pressure on the dong.

SBV responded by devaluing its reference rate by about 2%, widening the trading band once more, increasing supply of foreign exchange, and issuing data that showed that the preconditions for a balance-of-payments

3.31.3 Policy interest rates



Source: State Bank of Viet Nam.

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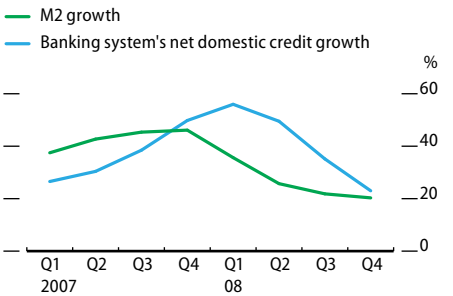
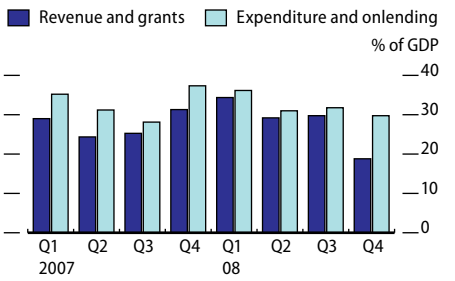
3.31.4 Money and credit indicators



Sources: State Bank of Viet Nam; staff estimates.

Click here for figure data

3.31.5 Government financial indicators



Note: Data include expenditure financed by official development assistance and by issuance of sovereign debt, but exclude lending through the Viet Nam Development Bank.

Sources: Ministry of Finance of Viet Nam; staff estimates.

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crisis were not in place. The formal market stabilized and the black market rate dropped to levels close to SBV's reference rate.

A shortage of foreign exchange reemerged in the formal market late in the year, as the near-term outlook for the global economy deteriorated rapidly and investors again moved substantial funds from dong- into dollar-denominated assets. To counter this, SBV devalued its reference rate by another 3.0%, bringing the cumulative devaluation for 2008 to 5.4%.

The trade deficit, after widening in 2007 and the first quarter of 2008, narrowed during the rest of the year (Figure 3.31.7). Year-on-year growth of exports accelerated in the first 3 quarters of 2008 owing to a combination of increasing export volumes and (in the first half) rising export prices. Export growth decelerated sharply in the fourth quarter, when external demand weakened significantly and export prices plummeted. Quarterly growth of imports slowed during 2008 (from a very high rate in the fourth quarter of 2007) reflecting the combined impact of the Government's efforts to rein in the trade deficit, the cooling economy, and, in the second half, falling import prices.

For 2008 as a whole, exports rose by 29.1% and imports by 28.1%; the trade deficit widened to $12.8 billion from $10.4 billion in 2007. This widening was outweighed by an increase in remittance inflows (recorded in the balance of payments mostly as inward current transfers). As a result, the current account deficit narrowed to an estimated 9.3% of GDP from 9.9% in 2007.

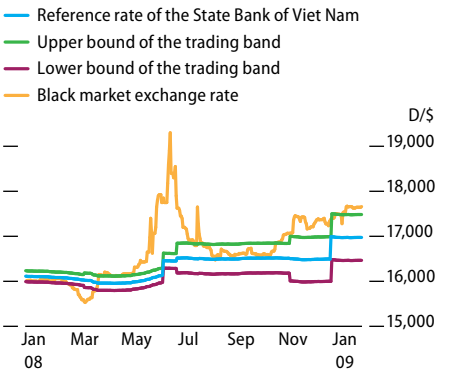
Despite tight global financial conditions, net foreign direct investment (FDI) inflows increased in 2008, in part reflecting government efforts to facilitate FDI projects. However, inflows of foreign portfolio investment plunged. The overall balance of payments recorded a small surplus, and gross official reserves rose to about $23 billion at end-2008 from $21 billion a year earlier (Figure 3.31.8).

The global financial crisis did not directly affect Viet Nam's banks, which are not yet deeply integrated into the international financial system. It did, though, contribute to declines in foreign portfolio investment inflows and stock prices. The VN Index of the Ho Chi Minh Stock Exchange fell by about two thirds in 2008 and continued to decline in early 2009. This caused delays in equitization (partial privatization) of state-owned commercial banks and other state enterprises. The drop in stock prices also contributed—along with the cooling of the real estate market and slowdown of economic growth—to an increase in nonperforming loans in bank loan portfolios.

Economic prospects

Near-term economic prospects are clouded by an unusually high level of uncertainty, primarily for two reasons. First, the global financial crisis and economic downturn are likely to reduce FDI and remittance inflows, as well as further crimp exports, foreign portfolio investment inflows, and overall growth. The global slump will also likely weigh on world commodity prices and reduce inflation pressures. The strength and duration of these effects will depend on how long global financial conditions remain weak and how deep and prolonged the global downturn will be.

3.31.6 Exchange rates



Sources: State Bank of Viet Nam; staff observations.

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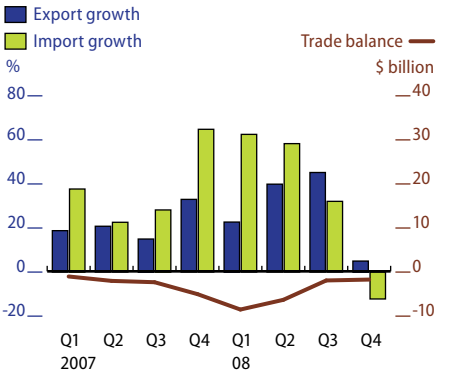
3.31.7 Trade indicators



Sources: General Statistics Office of Viet Nam; International Monetary Fund, *International Financial Statistics* online database, downloaded 27 February 2009; staff estimates.

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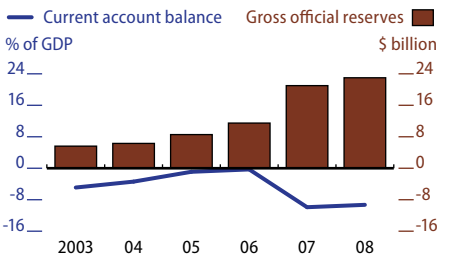
3.31.8 Current account and reserves



Note: Reserves exclude the Government's foreign exchange deposits at the State Bank of Viet Nam and the foreign exchange counterpart of swap operations.

Sources: State Bank of Viet Nam; International Monetary Fund, *Country Report* No. 07/386, available: http://www.imf.org; staff estimates.

Click here for figure data

Second, there is uncertainty about what additional fiscal stimulus the Government might adopt (beside the measures approved in January–February this year). Stimulus measures may well lift growth, but they are also likely to widen the fiscal and current account deficits, and may stoke inflation.

The baseline scenario for 2009 and 2010 assumes that the external environment will evolve in accordance with the expectations of this *Asian Development Outlook*. It further assumes that the Government will take some more fiscal stimulus measures (as well as those approved in January–February) in the total amount of about $1.0 billion in 2009. Furthermore, SBV is seen keeping monetary policy fairly loose, provided that inflation is subdued. Weaknesses in the banking system are not expected to lead to a systemic financial crisis.

Oil output is expected to rise to 15.5 million metric tons in 2009 and remain at that level in 2010. The country's first oil refinery, which started operations in February 2009 and is capable of processing 6.5 million metric tons of crude oil annually, is expected to reach full capacity by August this year.

On the above basis, GDP growth is projected to moderate to 4.5% in 2009 (Figure 3.31.9). Loose monetary policy and the fiscal stimulus will support public consumption and domestically financed investment; net exports are expected to increase. However, private consumption will slacken further because of slower economic activity, higher unemployment, and lower stock and property prices. The expected decline in FDI inflows will lead to a downturn in foreign-financed investment.

Growth is expected to rebound to 6.5% in 2010. With monetary policy remaining loose, the expansion of consumption and domestically financed investment will accelerate as the fiscal stimulus works through the economy. The forecast improvement of global financial conditions and the strengthening of external demand will bring about an upturn in foreign-financed investment and a further rise in net exports of goods and services.

Average annual inflation is forecast to slow to 4.0% in 2009, since GDP is likely to be below its potential level and world commodity prices are expected to be substantially lower than last year's average levels. Inflation will quicken to 5.0% next year on account of loose monetary policy, the expected modest rise in world commodity prices, and the projected rebound in growth.

The fiscal deficit is forecast to widen to 9.8% of GDP this year due largely to an expected decline in government oil revenue, a reduction in base corporate income tax from 28% to 25%, the slowdown of economic growth, and the fiscal stimulus measures. Despite the increase in oil output, oil revenue will fall because world prices are forecast to be much lower this year than last. The fiscal deficit will shrink to 5.3% of GDP in 2010. An expected rise in world oil prices next year (hence oil revenue), and the rebound of economic growth will boost total government receipts. Total spending will come down since no major fiscal stimulus measures are expected next year.

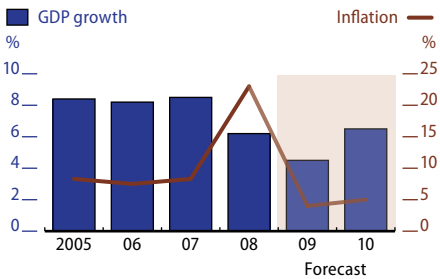
Because of the wide fiscal gap, the stock of public and publicly guaranteed debt will jump to 45.8% of GDP in 2009 from 39.7% in 2008 (Figure 3.31.10). It will fall to 45.1% of GDP in 2010 on account of the

3.31.1 Selected economic indicators (%)

	2009	2010
GDP growth	4.5	6.5
Inflation	4.0	5.0
Current account balance (share of GDP)	-11.5	-9.7

Source: Staff estimates.

3.31.9 Growth and inflation



Sources: General Statistics Office of Viet Nam; staff estimates.

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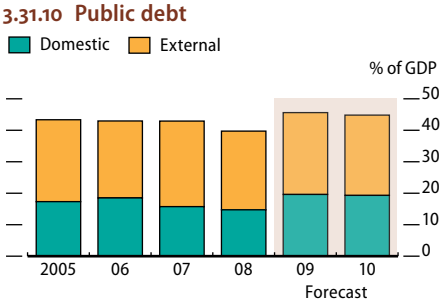
3.31.10 Public debt



Sources: Ministry of Finance of Viet Nam; staff estimates.

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smaller fiscal deficit and larger nominal GDP. The public debt burden should therefore remain moderate.

The current account deficit is forecast to widen to 11.5% of GDP in 2009. The start of domestic processing of oil, weak external demand, and lower export prices will reduce exports. Imports will decline even more than exports due to lower import prices, a steep drop in imports of refined oil products, and the economic slowdown. The narrowing of the trade deficit will be more than offset by smaller remittance inflows resulting from the anticipated worsening of the economic situation in origin countries. FDI inflows will decline as well, and inflows of foreign portfolio investment will remain small because of tight global financial conditions, increased economic uncertainty, and heightened risk aversion among investors. The overall balance of payments is likely to be in deficit this year.

In 2010, the current account deficit is expected to narrow to 9.7% of GDP. Higher external demand and export prices will boost exports, and remittance inflows will pick up, but these increases will be partly offset by an increase in imports due to a rise in import prices and the rebound in domestic economic growth. Inflows of FDI and foreign portfolio investment will climb, on the back of improved global financial conditions and investor sentiment. The overall balance of payments will return to surplus.

Risks to the forecasts posed by the uncertain external environment are tilted to the downside. As for domestic risks, if the Government takes more ambitious fiscal stimulus measures than the baseline scenario assumes, growth will be higher, the fiscal and current account deficits will be wider, public debt will be greater, and inflation may be steeper than in that scenario. As in the first half of 2008, higher inflation and a wider current account deficit may fuel inflation, cause capital flight, and create downward pressure on the dong. High inflation and exchange rate instability would have an adverse impact on economic growth over the medium term. Weaknesses in the banking system present a further downside risk (Box 3.31.1).

In the medium term, GDP growth is likely to pick up to 7–7.5%, driven by strong FDI inflows. Viet Nam remains an attractive destination for FDI despite the macroeconomic turbulence it experienced in 2008 and the serious economic difficulties it faces in the near term. Indeed, new FDI commitments more than trebled to $64.0 billion in 2008 from $20.3 billion in 2007 (Figure 3.31.11). Although actual FDI inflows are projected to decline this year, they are expected to rebound in 2010 and remain buoyant over the medium term. A government decision in October 2008 to allow full privatization of certain state enterprises, in particular through their sale to foreign investors, will likely spur further FDI inflows.

Development challenges

Due to rapid economic growth, Viet Nam was able to reduce unemployment and poverty considerably in recent years. The current economic slowdown, however, is undoing some of these gains (Box 3.31.2).

In the short term, the Government can bolster sagging growth through expansionary macroeconomic policies. However, expansionary

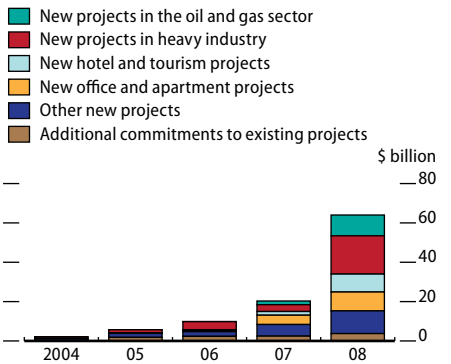
3.31.1 Banking vulnerabilities

Viet Nam has a large number of banks, many of which are fairly small. Some banks have a low capital-adequacy ratio, have made insufficient provisions for bad loans, and are vulnerable to shocks. According to the State Bank of Viet Nam, the share of nonperforming loans in bank loan portfolios increased to 2.1% at the end of 2008 from 1.5% a year earlier.

However, the asset classification system used by most banks in Viet Nam tends to underestimate the nonperforming loan ratio. The ratio for the entire banking sector would most likely be higher if all banks adopted a more stringent classification system. That share is likely to rise further in 2009 in the context of slowing economic growth and depressed asset prices.

Nonetheless, the probability of a systemic banking crisis is low. The central bank is strengthening prudential regulation and supervision of banks and has suspended the licensing of new banks so that it can focus on supervising the existing ones. If a bank becomes financially distressed, the central bank is likely to provide liquidity support to that bank or initiate its merger with another bank (or do both), to ensure that the problem bank does not cause a systemic crisis.

3.31.11 New foreign direct investment commitments



Source: General Statistics Office of Viet Nam.

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fiscal policy is likely to raise the fiscal deficit and the public debt burden. The Government may find it difficult to rein in the fiscal deficit later, both because of larger interest payments, and because of likely resistance to higher taxes and lower spending. Domestic financing of the fiscal deficit will increase money supply or crowd out private investment, or both, and may fuel inflation and hinder growth in the medium term. External financing of the fiscal deficit will increase the external debt burden. Expansionary monetary and fiscal policies, and increased external debt service, will widen the current account deficit (which is already quite large) and may destabilize the macroeconomic situation again.

It is therefore important that the Government strike a balance between stimulating growth and keeping the fiscal and current account deficits in check, as it tries to counter the impact of the global financial crisis and economic slump. Achieving this balance requires the Government to be particularly careful in taking additional fiscal stimulus measures, and to avoid spending on low-return public investment projects. It should prioritize social assistance to the unemployed and the poor, as well as support for small and medium-sized enterprises, and export-oriented industries. It could also make greater efforts to facilitate implementation of FDI projects and speed up the disbursement of official development assistance. Further increasing exchange rate flexibility would help prevent expectations of a sharp devaluation that can arise from a large current account deficit.

A major medium-term economic challenge for Viet Nam is to ratchet up growth without fueling inflation and increasing the current account deficit. To this end, the Government needs to intensify its efforts to raise the efficiency of the economy and ease supply-side constraints on growth, notably by removing infrastructure bottlenecks, improving the legal and regulatory framework for private sector development, strengthening public administration, and increasing the supply of skilled labor.

Restructuring state enterprises is crucial for raising the efficiency of the economy, since they employ a substantial proportion of available resources but do not use them very efficiently. These entities need to be restructured and their involvement in noncore businesses curtailed in order to utilize scarce resources more efficiently and to improve productivity. It is also important to subject them to hard budget constraints and to maintain adequate control over their finances to limit the Government's contingent liabilities. A decision by the Government in February 2009 to restrict state enterprise investments in noncore businesses (especially in financial companies) was a step in this direction.

The experience of the transition countries of Central and Eastern Europe and the former Soviet Union shows that privatization of state enterprises can lead to their restructuring and improved efficiency, though it is neither a necessary precondition for, nor does it guarantee, successful restructuring. Hence, even if market conditions are currently unfavorable for such privatization, the Government should accelerate restructuring of state enterprises, and, as soon as market conditions improve, speed up their privatization.

3.31.2 Unemployment and poverty

Viet Nam has generated millions of new jobs in recent years. The number of employed people rose from 37.8 million in 1999 to 44.2 million in 2007. The unemployment rate in urban areas fell from 6.7% in 1999 to 4.6% in 2007, despite substantial labor migration from rural to urban areas. The poverty rate dropped from 37.4% in 1998 to 16.0% in 2006, based on household survey data. According to the World Bank, the proportion of people living on less than $1 a day based on purchasing power parity (PPP) fell from 16.9% of the total population in 1999 to 4.0% in 2007, and the proportion of those living on less than $2 a day (PPP) declined from 65.9% to 32.9%.

Last year, however, the unemployment rate in urban areas rose to an estimated 5% as growth slowed and many firms cut jobs. Anecdotal evidence suggests that unemployment and underemployment increased in rural areas too, although agriculture performed relatively well. Many people from rural areas who were employed in cities but lost their jobs moved back. In addition, high inflation pushed many low-income households into poverty.

Unemployment and underemployment are likely to increase further and more households may fall into poverty this year, as growth continues slowing. Therefore, the Government should ensure that the poor and unemployed get assistance in the fiscal stimulus measures.

The Pacific

Fiji Islands
Papua New Guinea
Democratic Republic of Timor-Leste

Cook Islands
Kiribati
Republic of the Marshall Islands
Federated States of Micronesia
Nauru
Republic of Palau
Samoa
Solomon Islands
Tonga
Tuvalu
Vanuatu

Fiji Islands

Modest growth in 2008 was achieved in the face of rising inflation and continued political uncertainty, which eroded business confidence and aid from donors. The economy is expected to contract in 2009, owing to severe flood damage early this year and the impact on tourism and remittances of the global downturn. A significant improvement in prospects depends on a return to elected government and on reforms to encourage investment.

Economic performance

Rebounding from a 6.6% contraction in 2007, the economy grew by 1.2% in 2008 (Figure 3.32.1). An 8.7% increase in visitor arrivals in the 12 months to November contributed to the turnaround, although price discounting to attract tourists suppressed income (Figure 3.32.2). Wholesale and retail trade grew by an estimated 3.0% in 2008, hotels and restaurants by 6.0%, and transport and communications by 3.2%.

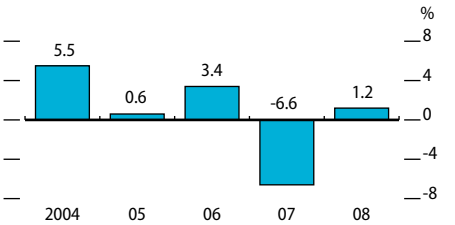
Gold (rebuilding from almost no output in 2007) and mineral-water production also rose last year. However, bad weather reduced sugar output by 7.0%, to the lowest level since 1962. Manufacturing recorded growth of just 0.9%, weighed down by the contraction in recent years of the clothing and footwear industry, which has faced an erosion of its concessional access to the Australian, New Zealand, and United States (US) markets.

This low rate of economic growth partly reflects the impact of the December 2006 military coup, which installed an interim government. In particular, lack of progress toward elections has led to a reduction in assistance from traditional donors and multilateral agencies. The European Union, for example, has approved the disbursement of only €4 million of €64 million it planned to provide as assistance for the sugar industry in 2006-2010. Moreover, business confidence slumped after the coup. Low economic growth also reflects structural problems that have constrained economic performance for two decades, hampering investment, exports, and employment creation.

The interim Government acted to moderate the inflation impact on end-users of higher world oil prices by reducing duties on fuel. Nevertheless, inflation accelerated to a 20-year high of 9.8% in September 2008 year on year, driven by rising food and fuel prices coupled with second-round effects of higher oil prices, such as on transport. Inflation decelerated to 6.6% by year-end as global oil and commodity prices declined (Figure 3.32.3), averaging 7.7% for the year.

The Reserve Bank of Fiji maintained a generally firm monetary policy stance since late 2006 to protect shrinking foreign reserves and to curb inflation. Some credit restrictions were eased in 2007 and 2008. Growth of private sector credit picked up, but remained low at 4.8%.

3.32.1 GDP growth



Sources: Fiji Islands Bureau of Statistics, available: http://www.spc.int/prism/country/fj/stats/Economic/gdp_summary.htm, downloaded 4 February 2009; Ministry of Finance and Planning, *Economic and Fiscal Update: Supplement to the 2009 Budget Address*, November 2008.

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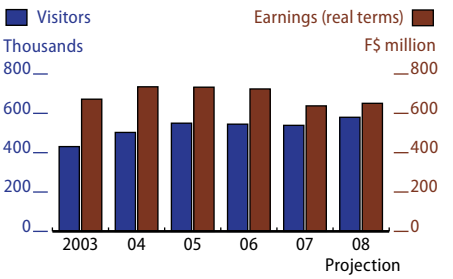
3.32.2 Visitors arrival and earnings



Source: Ministry of Finance and Planning, *Economic and Fiscal Update: Supplement to the 2009 Budget Address*, November 2008.

Click here for figure data

This chapter was written by Emma Ferguson of the Pacific Subregional Office, ADB, Suva.

Global economic conditions—primarily high oil prices—added to balance-of-payments pressure in 2008 (oil accounts for about one third of the import bill). Imports rose by 26.2%, outpacing export growth of 23.1% and pushing the trade deficit out to an estimated F$2.1 billion. The current account deficit widened to about 21.0% of GDP, from 17.3% in 2007. Official reserves fell to the equivalent of 2.7 months of imports by end-February 2009 (Figure 3.32.4).

Remittances from Fijians abroad, the biggest source of foreign exchange after tourism, fell to 3.3% of GDP in 2008 (Figure 3.32.5), continuing a downtrend from a peak in 2005. A slackening in offshore employment opportunities owing to the global economic slowdown and an appreciation of the local currency against the Australian and New Zealand dollars contributed to the decline in remittances.

An expanded capital investment program that the interim Government had planned for 2008 faced delays, reflecting a lack of project implementation capacity in some ministries. Government staffing costs, which constitute nearly half all public operating expenditure, rose by 0.9% in 2008, when pay cuts made in 2007 were partly restored. Receipts from direct taxes rose by 0.9% and from indirect taxes by 1.7%. The overall fiscal deficit for 2008 is estimated at 1.5% of GDP. General government debt as a ratio to GDP was 48% at year-end, down from 50.3% in 2007. About 85% of it is domestic debt.

The real effective exchange rate index appreciated by 1.8%, indicating a worsening in international competitiveness against major trading partners.

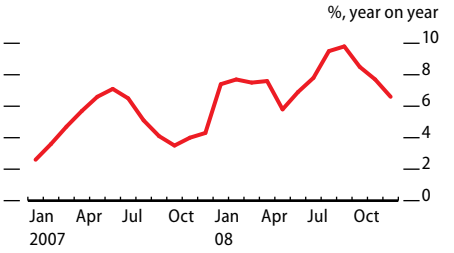
Economic prospects

The economic slowdown in the country's main trading partners, especially Australia, Japan, New Zealand, and the United States, will put downward pressure on tourism earnings and remittances this year. Additionally, severe flooding in January this year caused about US$60 million of damage (equivalent to 2.2% of GDP) to sugar, other crops, and livestock as well as to physical infrastructure such as roads and electricity facilities, according to preliminary official figures. Private sector losses in Nadi were estimated at over US$160 million. Tourism facilities were generally spared, but overseas reports about the floods will have some negative impact on tourism in the early part of this year.

While reconstruction efforts will generate activity and jobs in flood-affected areas, to some extent this will be at the expense of activity elsewhere. The outcome is expected to be a GDP contraction of 0.5% this year.

A potential positive element for the economy is an expansionary 2009 budget designed to favor growth and the poor. Planned extra spending is expected to contribute to a widening of the budget deficit to 3.0% of GDP, despite some offsetting revenue-raising measures. The focus is on development of agriculture and rural infrastructure. Government debt is projected to stay at the 2008 level, 48% of GDP. The expanded capital investment program pursued in 2008 has continued into 2009, though implementation hurdles make it unlikely that all capital spending targets will be met.

3.32.3 Inflation



Source: Fiji Islands Bureau of Statistics, available: http://www.spc.int/prism/country/fj/stats/, downloaded 4 February 2009.

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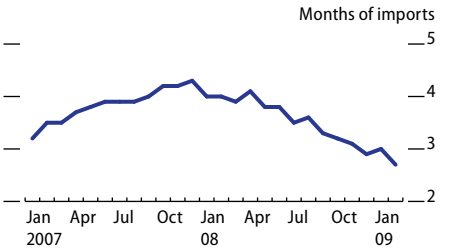
3.32.4 Reserves



Source: Reserve Bank of Fiji, *Monthly Economic Review*, various issues.

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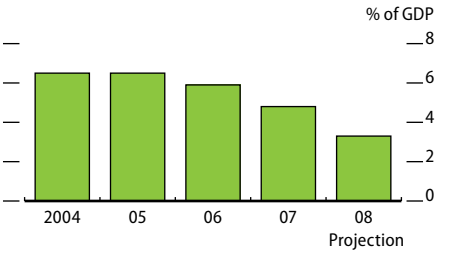
3.32.5 Remittances



Note: The 2008 projection is based on data to July.

Sources: Reserve Bank of Fiji, *Monthly Economic Review*, various issues; staff estimates.

Click here for figure data

Indeed, investment overall is expected to remain slack, reflecting weak business confidence, reduced access to funding from abroad, and the chronic problem of high levels of government operating expenditures (mainly the result of a large public payroll) that compress capital expenditures. Investment as a ratio to GDP has been relatively low at about 15%, and is expected to decline this year.

The trade gap is expected to widen as external demand weakens. This will exert further pressure on foreign reserves, which are already low. The current account deficit is projected at about 25% of GDP in 2009 and 2010, reflecting the deterioration in merchandise trade and reduced transfer payments. Inflation is forecast to fall to 4.5% in 2009, given weaker global prices of oil and other commodities.

GDP growth is expected to resume at a low level of 0.2% in 2010, if trading-partner economies start to recover as assumed. The economic outlook also heavily depends on the interim administration holding national elections. Not only does this have a bearing on business confidence, it is integral to accessing European Union funds for much-needed sugar reforms, as well as grant funds from Australia and New Zealand. In late 2008, the interim prime minister stated that there would be no elections in 2009. Responding to this, leaders of Pacific Islands Forum member countries meeting in late January this year announced that Fiji Islands' representatives would be excluded from Forum activities, and that other sanctions might be imposed unless a 2009 election date were announced by 1 May.

3.32.1 Selected economic indicators (%)

	2009	2010
GDP growth	-0.5	0.2
Inflation	4.5	4.5
Current account balance (share of GDP)	-25.0	-25.0

Source: Staff estimates.

Development challenges

There are indications that the incidence of poverty is rising, a result of long-term declines in the sugar and clothing industries, the impact of several coups, and, more recently, external shocks that raised food and fuel prices and further undermined growth. Over 25% of the population has an income below a basic needs poverty line. Pockets of deep poverty are found in town squatter settlements and more widespread poverty is apparent in rural areas. Much of the poverty reflects poor housing and lack of access to health and education services. The country has, in fact, a very low incidence of hunger and malnutrition.

Economic performance has been lackluster for some time: GDP growth averaged 1.7% in the 10 years to 2007 (1.2% on a per capita basis). Investment is discouraged by political instability (with four coups since May 1987), a cumbersome regulatory and tax environment, and weaknesses in property rights.

Sustainable growth is likely to require a better climate for private-sector development so as to generate jobs and exports. The interim Government is offering tax incentives in an effort to attract investment in export industries. But this move does not address the fundamental constraints and it risks weakening the fiscal position, particularly if it leads to demands for tax breaks by other industries, and if other countries undercut the incentives by offering similar or more generous concessions.

Papua New Guinea

Booming commodity prices underpinned growth in the economy and in government revenue in recent years. GDP growth accelerated a little in 2008, and inflation shot up. The plunge in global commodity prices is expected to pull down growth this year, and inflation is likely to moderate. The Government can draw on savings made in the boom years to support its spending, but also needs to put a higher priority on infrastructure investment and extending basic services.

Economic performance

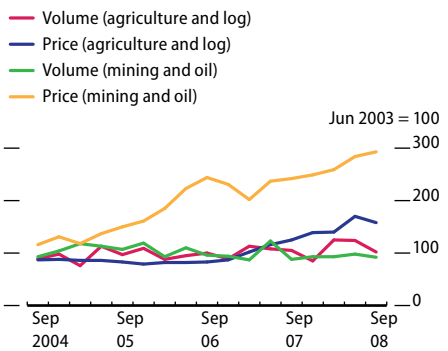
A country with crude oil, metals, and agricultural commodities, Papua New Guinea continued the trend of earlier years to perform strongly in the first half of 2008 on the back of high world commodity prices. GDP growth for the year accelerated to an estimated 7.2%, the highest for over a decade. It was fairly broad-based: services grew by an estimated 9.2%, industry by 7.8%, and agriculture by about 5.0%. This outturn was achieved despite a slowdown in crude oil production, which reflected the gradual depletion of established oil fields.

Strong gains in government revenue during the global commodities boom allowed for a 3% increase in real public expenditure in 2008. Private spending also continued to rise as incomes moved higher, along with commodity prices. Improved business confidence, supported by political and fiscal stability, helped sustain private investment. Expansion of mobile communications (after deregulation of the industry), of construction, and of new mining projects all made solid contributions to GDP growth.

Merchandise exports in nominal US dollar terms rose by 22.9% in 2008, largely driven by higher prices for export commodities (Figure 3.33.1). Mining (mainly copper and gold) and crude oil exports together rose by an estimated 21% in United States (US) dollars (Figure 3.33.2), despite a contraction of about 4% in volumes. The value of oil exports jumped by about 26%, with price increases outweighing a 20% volume contraction. Agricultural exports climbed by almost 30% in 2008. Strong performances were recorded in shipments of palm oil (44%), coffee (37%), cocoa (139%) and copra oil (98%). Export growth is estimated to have more than offset a 13.7% rise in imports, and the trade surplus increased to $2.8 billion. The current account recorded a surplus of about $700 million, equivalent to 8.7% of GDP.

Employment in the private formal sector increased by around 10% in the 12 months to June 2008. However, this accounts for only a small share of the labor force. The cash economy employs no more than one fifth of the population. Many people are farmers who produce mainly for their

3.33.1 Export indexes



Source: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, various issues.

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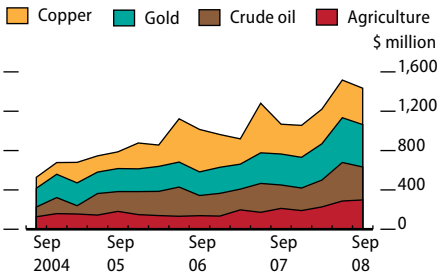
3.33.2 Exports



Source: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, various issues.

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This chapter was written by Dominic Mellor of the Papua New Guinea Resident Mission, ADB, Port Moresby.

own consumption, with some cash-crop production of products such as cocoa, copra, and coffee.

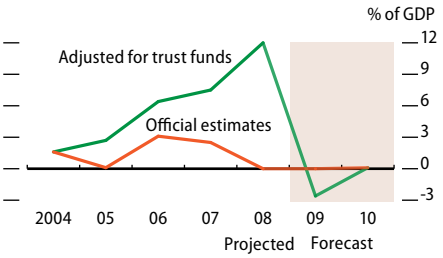
Since 2005, the Government has set aside some of its windfall revenue generated during the commodity price boom in "additional investment/priority expenditure" trust funds. The aim is to avoid unsustainable and inflationary increases in recurrent spending and to smooth outlays on social and infrastructure projects during the commodity cycle. By end-2008, trust fund accounts were valued at the equivalent of about 22% of GDP. Contrary to international standards, which treat such new deposits as saving, the budget records them as off budget items, an approach that led to a budget that was roughly in balance last year. Using international norms would have resulted in a budget surplus of almost 12% of GDP (Figures 3.33.3 and 3.33.4). The Government has raised repayments on its debt, lowering gross government debt to an estimated 29% of GDP by end-2008, or less than half the 2002 ratio. The ratio of external public debt to GDP declined to 13.0% in 2008.

Inflation accelerated last year to peak at 13.5% in the third quarter (year on year). The causes were strong growth in money supply and credit; higher costs of fuel, transport, and food staples; increased government spending; and shortages of rental properties and skilled labor. Average inflation was 10.8%, compared with just 0.9% in 2007.

The Bank of Papua New Guinea raised its monetary policy indicator rate in response to rising inflation. Still, lending to the private sector in 2008 rose by an estimated 40% and the money supply by 11.2%. The annual average kina exchange rate appreciated by 10.0% against the US dollar and by 11.4% against the Australian dollar.

The global slump deepened in the fourth quarter and checked the growth of both export income and government revenue, though to what extent is not yet clear. Gross foreign exchange reserves fell from a historical high of about $2.7 billion in August 2008 to just over $2.0 billion by year-end (equal to about 11 months of imports of goods and services) as foreign exchange inflows from exports declined.

3.33.3 Budget balance



Sources: Department of Treasury, *2009 Budget*, Volume 1; staff estimates.

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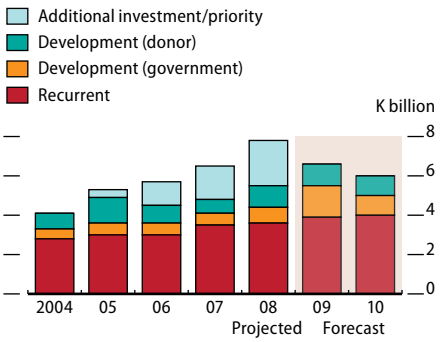
3.33.4 Government expenditure



Note: Data refer to 2004 prices.

Source: Department of Treasury, *2009 Budget*, Volume 1.

Click here for figure data

Economic prospects

GDP growth is expected to moderate to about 4.0% in 2009 and 3.5% in 2010 (Figure 3.33.5), as the global economic downturn erodes exports and government revenue, leading to reductions in commodity production, weaker growth in incomes, and generally softer domestic demand. Crude oil production is seen declining further, but mining output should be supported by the Hidden Valley gold mine, which is scheduled to start production in the middle of this year, and the Ramu nickel mine, which is expected to reach full capacity next year.

A large liquefied natural gas export project to cost about $12 billion is in the engineering and design stage. If the Government and energy companies involved make final decisions to proceed with the project, it could start production in 2013, and increase GDP by about 20% over its lifetime. Business confidence is likely to be underpinned by expectations that the project will go ahead. Nevertheless, construction activity overall is expected to slow this year and next, in part because many construction firms are operating at near full capacity.

3.33.1 Selected economic indicators (%)

	2009	2010
GDP growth	4.0	3.5
Inflation	7.0	6.0
Current account balance (share of GDP)	-7.0	-6.0

Source: Staff estimates.

The plunge in international prices of copper, crude oil, and many agricultural commodities, and the expected reduction in their production, will cause the value of exports to fall from 2008. Furthermore, severe flooding in the Highlands region in February and March 2009 will damage coffee and tea production, which usually peaks between March and June.

Merchandise imports will also decline as domestic demand softens. The trade surplus is expected to narrow and the current account to tip into deficit, equivalent to 7.0% of GDP this year and 6.0% in 2010 (Figure 3.33.6).

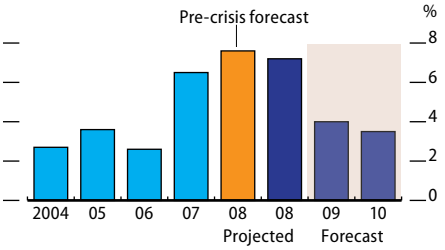
Commodity prices for most of the country's main exports have fallen further since the Government approved its 2009 budget in November 2008, further suppressing revenues. At the same time, expenditures are to remain elevated, with support from withdrawals from trust funds. The budget deficit is expected to be at least 3% of GDP this year.

Bank lending to the private sector ramped up during the commodity boom (Figure 3.33.7), and the quality of these loans could deteriorate as the economy slows. With this in mind, the banks will likely take a more cautious stance on lending, tightening credit and making it more expensive. Given the drop in mining and energy profitability, major projects that depend on foreign investment also face higher borrowing costs in global markets, as well as a more difficult environment for equity investment.

Inflation is projected to slow to around 7.0% in the forecast period (Figure 3.33.8). Falls in import prices of fuel, flour, and other commodities will trim inflation, but this will be somewhat offset by upward pressures generated by continued high levels of public spending, capacity constraints in construction, and short supply of rental housing. The central bank is unlikely to ease its monetary stance until it is sure inflation is coming down.

Foreign exchange reserves are expected to decline but are sufficient to enable the central bank to smooth any excess volatility in the exchange rates.

3.33.5 GDP growth



Sources: Department of Treasury, *2009 Budget*, Volume 1; staff estimates.

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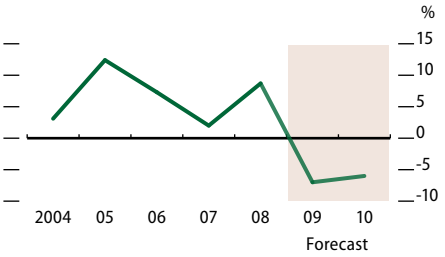
3.33.6 Current account balance



Source: Department of Treasury, *2009 Budget*, Volume 1.

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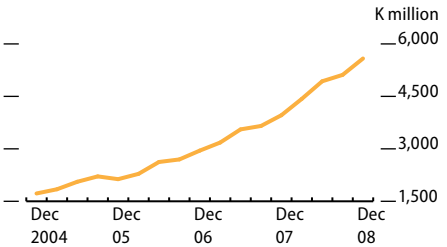
Development challenges

Public infrastructure continues to deteriorate in many parts of the country. The Government faces a critical need to manage fiscal savings from recent years and to use them to improve infrastructure and basic service delivery, as outlined in its medium-term development strategy. A related challenge for the Government is to manage public expectations that overall public expenditure can continue to rise quickly. Public financial management systems will be severely tested during the adjustment to more austere fiscal conditions.

Efforts to increase the level of real development expenditure have been hampered by a lack of skilled staff to plan and implement projects, especially at local level. The Government has sharply raised its grants for development spending to K14 million ($4.8 million) for each of the country's 89 districts. The capacity of local government to administer and effectively implement projects will need to be significantly enhanced if increased expenditure is to be translated to improved public service

3.33.7 Lending to the private sector



Source: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, various issues.

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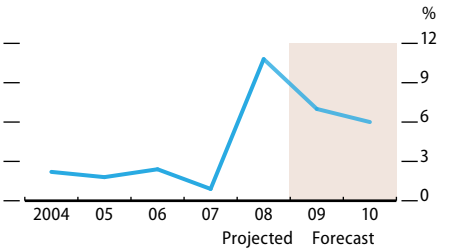
delivery. More broadly, increased investment in human and physical capital is needed to equip people with skills, provide basic services, and reduce the very high poverty incidence.

It will be important for the Government to pursue reforms to state-owned enterprises by increasing accountability, strengthening governance, and opening to competition those facilities dominated by the public sector, such as air and sea ports and electricity. Potential gains have been highlighted by the opening of the formerly government-owned mobile telephone sector. This resulted in notable improvements in phone services in rural areas. There are also promising signs in aviation, where consumers now benefit from lower international airfares offered on some routes by a competitor to the national carrier.

The Government last November approved a policy framework that paves the way for increased private sector participation in the economy though a greater role in public service delivery, such as physical infrastructure and health services. It will now draft laws and regulations and prepare a list of projects for public–private partnerships. Placing greater reliance on private sector development will require complementary efforts to improve the business environment. The World Bank's *Doing Business 2009* report ranks Papua New Guinea 95 overall in a list of 181 countries, but much lower on issues including enforcement of contracts and access to credit.

3.33.8 Inflation



Sources: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, various issues; staff estimates.

Click here for figure data

Democratic Republic of Timor-Leste

A large expansion in government expenditure and increased agriculture production lifted economic growth to an estimated 10% in 2008. Public spending, funded by revenue from offshore petroleum production, will continue to rise this year and keep economic growth high. Inflation is expected to ease. However, a rise in poverty points to the need for better targeted government spending to address a lack of basic services and rural underdevelopment.

Economic performance

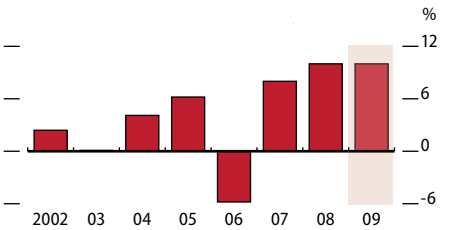
Expansion of public spending programs funded by revenue from offshore petroleum production spurred the economy in 2008. Actual government expenditure more than doubled from 2007 to reach an estimated $450 million. This lifted the ratio of government expenditure to GDP to the order of 100%, excluding petroleum and the United Nations (UN) contribution to government operations.

About 2,000 international security and police personnel are still in Timor-Leste, under the auspices of the UN, to support law and order following outbreaks of civil unrest, including extensive unrest in 2006 and attacks on the president and prime minister in early 2008. These international forces, combined with civilian support and a large donor presence, provide an important source of demand in the economy. Economic activity was also supported over the year by an improved political and security situation, one that, though generally calm, remains fragile.

Agriculture, which accounts for about 85% of employment, recovered after being hit in 2007 by bad weather. An increase in the harvested area saw rice production rise by 21% such that it met about 40% of annual requirements (100,000 metric tons). The public sector accounts for around half the employment outside agriculture. Wholesale and retail trading and other private services (petroleum operations are entirely offshore), engage much of the rest of the working population. Non-petroleum, non-UN GDP grew by an estimated 10% in 2008 (Figure 3.34.1).

The surge in international commodity prices in 2008 propelled inflation to as high as 10.6% in June, year on year (Figure 3.34.2). Inflation then eased as the international price of crude oil and other commodities declined, putting the year-end rate at 7.6%. The Government increased subsidies for imported rice in 2008, and this suppressed the impact of higher international food prices (Figure 3.34.3). Nevertheless, around half the inflation last year was attributable to higher food prices (food accounts for 58% of the consumer price index). Most of the increase in

3.34.1 GDP growth

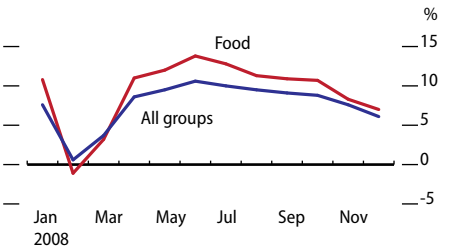


Note: Non-petroleum, non-UN GDP.

Sources: Government of Timor-Leste, *General Budget of State 2006–07 and 2008*.

Click here for figure data

3.34.2 Inflation



Source: Timor-Leste National Directorate of Statistics, *Consumer Price Index December Quarter 2008*.

Click here for figure data

This chapter was written by Craig Sugden of the Pacific Department, ADB, Manila; and Tony Ryan, consultant.

food prices was in turn a result of higher prices of rice, corn, and other cereals, as well as cassava and other root crops.

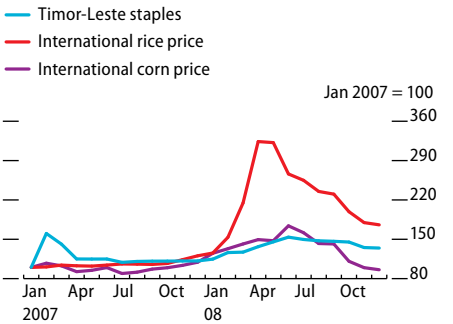
Strong growth in domestic demand was evident in a large rise in imports. Merchandise imports rose from $68.6 million in the first half of 2007 to $89.9 million in the first half of 2008. Excluding the offshore petroleum operations, merchandise exports (mainly coffee) are a small fraction of imports. Even after a bumper coffee harvest, merchandise exports totaled just $11.6 million in 2008.

Loans and advances by commercial banks leveled off in 2008, suggesting slower growth in private business activity (Figure 3.34.4). Broad money supply rose by 33.1% as the international forces increased deposits with the banking system. The shortage of lending opportunities saw the commercial banks' liquid asset ratio rise to 79.4% by end-2008 from 71.3% a year earlier. Nonperforming loans remain a problem for the banks, even though their ratio to total loans eased to 28.2% by end-2008 from 30.2% at end-2007.

Access to microfinance is largely limited to loans secured by public sector salaries. This hampers development of agribusiness, in particular, because loans are not generally available for the purchase of rural products. The poor pay very high rates of interest to money lenders, estimated at up to 25% a month.

The Government made transfer payments totaling around $100 million in 2008. These included subsidies for the aged and the vulnerable, pensions for former public office holders, and pensions for ex-combatants. It also paid people to return to their villages from temporary camps (more than 10% of the population was displaced by the 2006 violence). These payments supported consumption and helped achieve civil stability. However, outbreaks of civil strife remain a risk, as highlighted by heightened tension following the serious wounding of the president in a February 2008 attack.

3.34.3 Key food price indexes



Note: Timor-Leste price index for cereals, roots, and their products; Bangkok rice price; and US (gulf ports) corn price shown.

Sources: Timor-Leste National Directorate of Statistics, *Consumer Price Index December Quarter 2008*; International Monetary Fund, *International Financial Statistics* online database, downloaded 4 February 2009.

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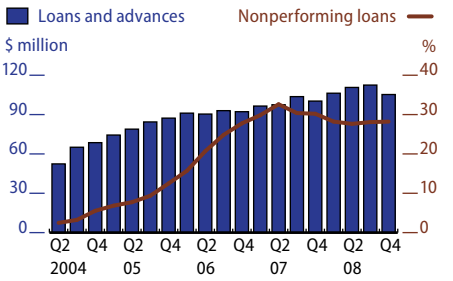
3.34.4 Lending indicators



Source: Banking and Payments Authority.

Click here for figure data

Economic prospects

The economy will remain dominated by government activities over the medium term. Almost all the Government's own revenue is drawn from the Petroleum Fund, which receives income from the nation's offshore petroleum production. The Petroleum Fund more than doubled in value to an estimated $4.2 billion by end-2008, almost all invested in United States (US) government securities. The use of the US dollar as the national currency protected Timor-Leste from adverse exchange rate effects.

Prior to 2008, drawdowns from the Petroleum Fund were limited to its "sustainable income," so that the Fund's capital would be maintained indefinitely. The Government budgeted to draw down more than the sustainable income in 2008, a decision that led to intense political debate. While the actual drawdown did ultimately match the end-year estimate of sustainable income, budgeted drawdowns for 2009 and 2010 are well above that rate.

The 2009 budget increases government expenditure to $902 million, almost double the 2008 estimate of non-petroleum, non-UN GDP. Much of the additional expenditure is for imported goods (including capital goods) and services, and so there will only be a muted effect on

3.34.1 Selected economic indicators (%)

	2009	2010
GDP growth	10.0	8.0
Inflation	7.1	6.5
Current account balance (share of GDP)	-	-

Source: Staff estimates.

GDP growth. The most direct impact on the economy will be from a further increase in public sector wages and salaries, which have almost tripled over 3 years. The Government also plans substantial spending on electrification (Box 3.34.1).

Non-petroleum, non-UN GDP is expected to grow by a further 10% in 2009, supported by a February 2009 decision of the UN Security Council to extend for at least 12 more months to February 2010 the UN Mission and international security presence. Nevertheless, civil unrest remains a downside risk for growth over the medium term. GDP growth is expected to ease in 2010 as budgeted declines in government expenditure feed through the economy (Figure 3.34.5). The actual outcome will rest on budget disbursement rates, which have been low (but increasing) in recent years because of difficulties in project planning and delays in procurement. Inflation is expected to ease in the forecast period to about 7.1% in 2009 and 6.5% 2010, as global food price inflation slows from 2008 levels.

Development challenges

The positive outlook for key economic aggregates masks deep poverty. The share of the population living below the poverty line increased from about 36% in 2001 to about 50% in 2007, according to the nation's second poverty study. Poverty is largely a rural problem (three quarters of the poor live in rural areas), although its incidence also is rising in towns. The Food and Agriculture Organization and World Food Programme have estimated that 30% of the population, for at least 2 months each year, lives on a diet that is insufficient to meet basic human needs. Food shortages arise from low agricultural output, high post-harvest cereal losses (up to 90% in upland corn), distortionary food subsidies, limited market access, and the very few alternative means of earning incomes in rural areas.

Low rural incomes, high population growth rates, rapid urbanization, and the after-effects of civil unrest are major challenges. The quality of government expenditure will be central to responding to them and to setting Timor-Leste's development path. The expansion in expenditure now under way has the potential to share the rapidly accumulating financial wealth with the population. Well-managed spending can generate additional wealth by converting low-return savings in financial instruments into high-return investments in human and physical capital.

More could be done to raise development returns from public expenditure. For example, the subsidization of imported rice shielded many people from rising international prices, but it also suppressed prices received by domestic growers. This damped a much-needed supply response from farmers, and consequently held down growth in their incomes.

Furthermore, the subsidies benefit the better-off more than the poor, as the better-off consume more rice and the poor rely more on corn and cassava. A government decision to hold 2 years of rice imports in storage as a buffer against price hikes will have similar side-effects, suppressing farm production and rural incomes. One alternative would be cash transfers to the poor. This approach would enable them to buy rice when the price rises and to pass on to farmers the benefit of the higher prices.

3.34.1 Electrification

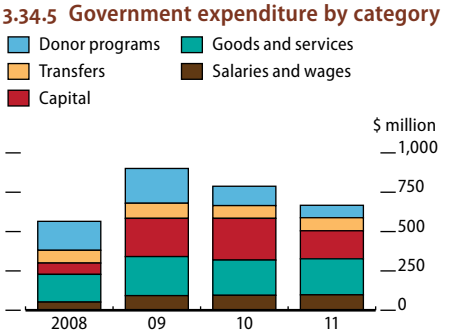
More than half the $616 million capital expenditure budgeted in 2009–2012 is to be spent on building power stations fueled by imported oil to electrify urban (and later rural) areas. The Government has contracted to install 180 megawatts (MW) in generating capacity by end-2010, with supporting transmission and distribution lines. This represents a very large increase on current capacity of 40 MW.

This electrification program was announced in mid-2008 and the contracts were signed by year-end. A longer preparation phase would have been helpful to allow a fuller consideration of development issues involved.

A key issue is whether the supply expansion will outstrip demand—a 2004 power sector study found the country needed 50–100 MW of additional capacity by 2025 to lift the electrification rate to 80% from 20%. Another issue is whether electrification should be such a high budget priority.

Electricity is a service that can be at least partly self-funded from user charges. But because services such as law and order, road maintenance, and education and health services for the poor generally cannot be self-funded, they should be the priority for budget resources.

3.34.5 Government expenditure by category



Sources: Government of Timor-Leste, *General Budget of State 2006-07 and 2008*; Directorate of Treasury, Ministry of Planning and Finance, *Democratic Republic of Timor-Leste Annual Financial Report and Accounts 2005-06 and 2006-07*; staff estimates.

Click here for figure data

Small Pacific countries

Global influences are buffeting these 11 small Pacific economies. Rising prices for imported food and fuel in the first half of 2008 suppressed consumption spending and pushed up inflation in many of them. The global economic slowdown started to curtail tourism and remittance inflows, and erode prices of export commodities, while the global financial crisis is slashing the value of investments held in trust funds by some of the countries. Growth slowed, or output contracted, in about half the economies last year. The rest grew a little faster than in the previous year. In 2009, most are forecast to record slower growth, or a contraction in GDP. Inflation accelerated in all the countries in 2008, and to double-digit rates in five of them, but is expected to ease this year.

Box 3.35.1 discusses the impact of the global financial crisis and the economic downturn on the Pacific economies.

Cook Islands

Hurt by a 3.0% decline in visitor arrivals, the economy grew by an estimated 1.1% in 2008 (Figure 3.35.1). Tourism is the main industry—annual visitor arrivals of around 100,000 compare to a resident population of around 15,000 persons. The decline in tourist arrivals was concentrated in visitors from Canada, Europe, and the United States (US), the high-spending segments of the market. Arrivals from New Zealand, the main source of tourists, rose by 3.3%.

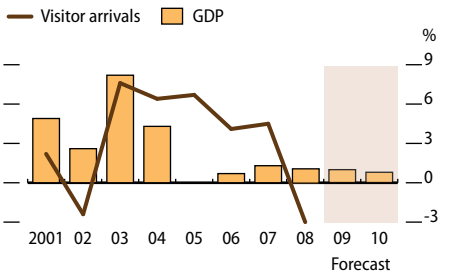
Investment in tourism has driven the economy since the mid-1990s, but it tapered off last year. The number of available room nights flattened out, after recording growth of 4.6% in 2006 and 9.2% in 2007. A government policy allowing 100% tax deductibility for capital expenditure ended in 2008, and that appears to partly account for the slowdown in such investment.

Merchandise exports, mainly fresh fish and pearls, continued to weaken and are now less than 5% of the estimated value of tourism expenditure. The loss of one of only two shipping services to the country also contributed to the weak economic performance.

Inflation peaked at 11.8% year on year in the third quarter of 2008 and eased to 9.2% in the fourth. The annual average inflation rate of 7.8% was well above the 2.5% recorded in 2007, and was driven by higher prices for food, fuel, electricity, and greater household rents and mortgage costs.

The fiscal balance deteriorated in FY2008 (ended 30 June 2008) as the operating surplus declined (Figure 3.35.2). This was largely a result of a further increase in the Government's wage and salary bill, following cost-of-living adjustments and an expansion in public employment. The

3.35.1 Growth in GDP and visitor arrivals, Cook Islands



Sources: Cook Islands Statistics Office: *Annual Statistical Bulletin 2008* and online database, downloaded 12 February 2009; staff estimates.

Click here for figure data

This chapter was written by Craig Sugden and Raquel Tabanao of the Pacific Department, ADB, Manila; Emma Ferguson and Laisiasa Tora of the Pacific Subregional Office, ADB, Suva; Milovan Lucich of the Pacific Liaison and Coordination Office, ADB, Sydney; and Rommel Rabanal, consultant.

3.35.1 The impact of the global slowdown on the Pacific

The global economic slowdown and financial crisis have hurt Pacific economies in several ways. Commodity exporters have suffered a drop in export income and government revenue because of lower world commodity prices. Countries with trust funds invested in international financial markets have seen the value of their funds drop, which will likely reduce income streams to national budgets. Some economies rely heavily on income from tourism or remittances, sometimes both, and they are expected to weaken as many of the source countries—generally the wealthy Pacific Rim nations—are in recession. International funding for new projects, particularly those involving commodities and energy, will be more expensive or even unobtainable.

Export prices for producers of agricultural and mining commodities and energy (notably Papua New Guinea, Solomon Islands, and Timor-Leste) have dropped, and export volumes of some commodities are likely to fall in 2009. Governments in Papua New Guinea and Timor-Leste saved some of their surging revenue flows during the commodity boom, which will help to support public spending and their economies through this period of lower commodity prices. But Solomon Islands lacks this cushion, and faces a rapid decline in output of logs, its major export.

Several Pacific economies—Kiribati, Marshall Islands, Federated States of Micronesia, Palau, Timor-Leste, and Tuvalu—have substantial public savings invested in offshore financial markets. The value of most of these funds has plunged, in tandem with the markets. (Timor-Leste's fund is invested mainly in US Government securities, so it weathered the global financial crisis.) So far, governments do not appear to have reduced public spending to compensate. Kiribati and Tuvalu in particular need to trim government spending quickly so as to match the decline in the value of their offshore investments. The longer this adjustment is deferred, the greater the overall impact of the global slump is likely to be.

Economies that rely on tourism or on remittances from workers abroad, or both, are likely to see little growth or declines in earnings from these sources. Tourist departures to the north Pacific from Asia and the United States have already fallen by about 10% in 2008. Palau, which relies on tourists from Japan and Taipei,China (both in recession), has experienced a decline in tourism, despite a heavy marketing effort in Japan. Tourist numbers to Cook Islands, Samoa, and Tonga are likely to fall in 2009, given recession in New Zealand (an important source for their tourist businesses), while Fiji Islands and Vanuatu come up against expected subdued growth, at best, in tourist arrivals from Australia.

As for remittances, the United States and New Zealand labor markets, two of the three key sources for Pacific countries, weakened early in 2008 and Australia, the third, has since followed. The deterioration in these three sources suggests that the decline in the real value of remittances to the Pacific seen in 2008 will become more pronounced in 2009. Samoa and Tonga are the most exposed, followed by Fiji Islands and Federated States of Micronesia.

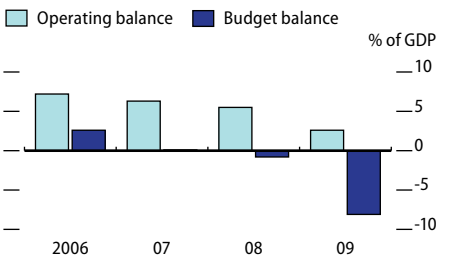
Government, recognizing that this bill is approaching unsustainable levels, has frozen public service employment.

A large fiscal deficit is budgeted for FY2009; capital expenditure has expanded while collections of value-added and income taxes have declined. The Government has secured a loan equivalent to about 4% of GDP from the People's Republic of China (PRC) to build a new headquarters for the Ministry of Education and a new sports stadium. Avatiu harbor and Rarotonga airport will be upgraded and the Government is considering buying fuel tank farms in an effort to create a public monopoly, which it hopes will lower the price of fuel.

Recurrent costs are also rising. The Government has budgeted for an NZ$3 million economic stimulus package to provide subsidized loans to businesses, and will continue to subsidize a direct air route to the US, with the budget provision equivalent to 1.5% of GDP this fiscal year, twice that of last year.

Growth is expected to remain low. Tourism to the Pacific from New Zealand showed signs of slowing late in 2008 as that economy contracted. A number of special events scheduled for 2009 (a mini-South Pacific Games and a world youth netball championship), as well as the proposed

3.35.2 Government fiscal position, Cook Islands



Sources: Government of Cook Islands, *Appropriation Bills*, various issues; staff estimates.

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public construction projects, are expected to support GDP growth of 1.0% in 2009.

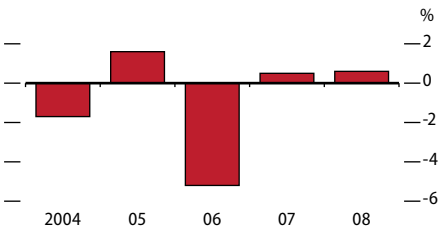
As the Cook Islands uses the New Zealand dollar as its domestic currency, inflation is expected to ease this year to 5.1% as recession pulls down inflation in New Zealand.

An increase in productivity, which was achieved after reforms in the mid-1990s, appears to have dissipated, and follow-on reforms have not been pursued. Moreover, capital accumulation has slowed because of tighter restrictions on foreign investment. New efforts are required if economic growth is to return to moderate levels. The initial priorities are to follow through on plans to contract out the operation of the fuel tank farms that the Government plans to buy and to ensure that government contracts that involve subsidies are open to competitive bidding. Over time, it will be important to reduce the size of the public service and the overall cost of government, to privatize state enterprises, and to improve tourism infrastructure on Rarotonga and Aitutaki.

Kiribati

This economy is dominated by a large public sector that provides two thirds of all paid employment and close to half the GDP. Almost half of national income comes from external sources, predominantly fishing license fees, seafarers' remittances, development assistance, and revenue from the country's Revenue Equalisation Reserve Fund (RERF), an offshore investment fund. GDP grew by an estimated 0.6% in 2008 (Figure 3.35.3), supported by high levels of government expenditure.

3.35.3 GDP growth, Kiribati



Sources: Kiribati National Statistics Office; staff estimates.
Click here for figure data

Reflecting higher global oil prices, the fuel import bill climbed to an estimated A$27 million, representing an increase over 4 years of the equivalent of 15% of GDP; during the same period the cost of imported food grew by the equivalent of around 5% of GDP. Not all the rises in fuel costs were passed on to consumers, and instead were partly covered through higher subsidies, borrowing by state enterprises, and a grant of fuel from Japan. A government restriction on the profit margin allowed on rice sales; and a grant of rice from Taipei,China helped limit the rise in rice prices. Still, inflation rose to an average of 11% in 2008.

The market value of the RERF, the key source of government income, fell by an estimated 20% last year, along with the slump in global financial markets. Drawdowns from the RERF to fund the budget deficit (about A$40 million was taken out in 2008) are unsustainably high and spending cuts are required to reduce the drain on the fund. In addition, revenue from fishing licenses dropped by 22% in 2005–2007 compared with 2002–2004. The outlook is poor for these fees owing to governance shortcomings that put the commercial viability of fish stocks at risk. Further, the year-on-year variation in license earnings is unpredictable, because of the migratory nature of the fish stock and the influence of climate on fish migration.

Remittances have been fairly stable at around US$8 million a year, though their local-currency value fluctuates. The weak global economic outlook suggests that employment for seafarers will be curtailed in 2009–2010, but this could be offset by new opportunities for seasonal work in Australia under that country's new temporary labor arrangement.

Economic growth is forecast at around 1.0% in 2009. Inflation is seen slowing to 6.5% because of lower average prices of imported food and fuel.

Longer term, if the economy is to sustain growth, the Government needs to find new revenue sources and improve the management of its revenue and expenditure. Reform of the civil service and public enterprises could provide significant budget saving.

As a low-lying atoll nation, Kiribati is vulnerable to the effects of global climate change, but it has barely started to put in place adaptive measures such as water-storage systems and drought-resistant crops. Moreover, rapid population growth is retarding social and economic progress. Expanded technical training is needed to assist workers in competing for better-paying jobs abroad.

Republic of the Marshall Islands

GDP grew by an estimated 1.5% in FY2008 (ended 30 September 2008), mainly on the back of a grant-financed increase in public expenditure. Copra production rose in response to high international prices, and production exceeded 7,000 tons for only the third time in 50 years.

High prices for imported fuel, coupled with price increases for electricity, transportation, and rice, propelled inflation to 29.4% year on year in the third quarter of 2008 (Figure 3.35.4). This was the highest inflation rate in the Pacific, an outcome that reflected the economy's remoteness and very high import dependency.

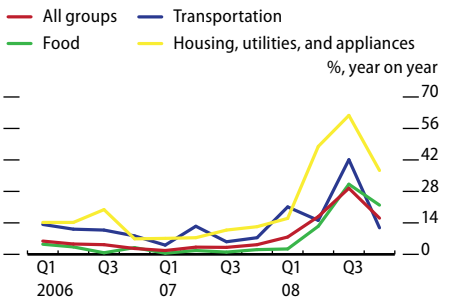
Efforts were made last year to reduce electricity usage as fuel costs rose. That culminated in the signing on 30 January 2009 of the Majuro Energy Declaration, an agreement between civil society, the private sector, and the Government that maps a path toward greater energy efficiency and security. Nevertheless, fuel imports claimed almost 20% of the national budget in FY2008. Funds for capital projects (specifically a grant from Taipei,China) were redirected to finance the fuel imports. Tax collections declined to an estimated 16.0% of GDP in FY2008 from 17% in FY2007. Government revenue was eroded by layoffs at the US military base on the island of Kwajalein.

In the FY2009 budget, the Government has reduced discretionary expenditure (such as travel) in an attempt to increase capital spending and repair its fiscal position. Japan contributed significant grant funding, but the budget continues to depend heavily on funds from the US under the amended Compact of Free Association. US grants account for 63.8% of projected revenue and grants.

The slump in global financial markets cut the value of the Compact Trust Fund from US$93.1 million in January 2008 to US$72.1 million in November. While this does not have an immediate effect on the fiscal position, because the Fund was set up for long-term saving, extra efforts are required to curb expenditure and raise revenue so as to generate more saving to rebuild the Fund. Public debt remains very high (Figure 3.35.5) and arrears on that debt are a continuing problem.

Economic growth is expected to remain low, at only 0.5%, in FY2009. Inflation will ease to about 9%, mainly because of the decline in oil prices, although damage to crops caused by high waves in January 2009 delayed an expected reduction in food prices. In a helpful development, the US

3.35.4 Inflation by major group, Republic of the Marshall Islands



Source: Economic Policy Planning and Policy Office, *Republic of Marshall Islands Consumer Price Index*, various issues.

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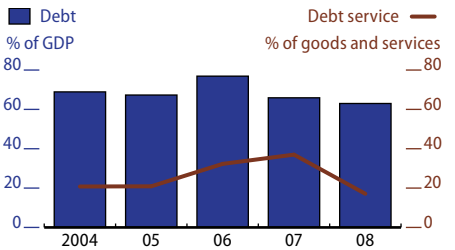
3.35.5 External debt indicators, Republic of the Marshall Islands



Sources: Economic Policy Planning and Policy Office, FY2007 Economic Statistical Tables, September 2008; International Monetary Fund, *Country Report*, June 2008.

Click here for figure data

accreditation agency removed, in February 2009, its sanctions on the College of the Marshall Islands. It had previously identified shortcomings in training. (Given a shortage of job opportunities at home, the US is an important employment outlet for young Marshallese.)

The private sector could make a greater contribution to growth and employment creation in this economy, which is dominated by the public sector (the general government wage and salary bill is almost 22% of GDP). Development of private activity requires improved access to finance and land, reforms to ineffective laws and regulations, better infrastructure, and more efficient state enterprises.

Federated States of Micronesia

Continuing the poor performance of recent years, GDP contracted by an estimated 1.0% in FY2008 (ended 30 September 2008) (Figure 3.35.6). The lackluster outturn reflects delays in disbursement for public works under financial assistance arrangements with the US. Economic performance is largely driven by US grants under the Compact of Free Association, of about 25% of GDP. Growth was also hampered by the erosion of household spending power by a doubling of inflation to 5%. Exports remained weak at around 10% of GDP in FY2008, or less than 15% of imports.

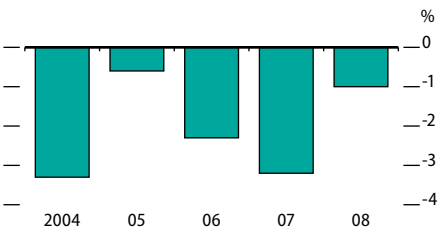
The Government reined in the overall fiscal deficit to about 3.0% of GDP in FY2008 from over 6% in FY2006 (Figure 3.35.7). This followed the receipt of additional grants from the PRC and cuts in public sector spending in the states of Chuuk and Kosrae, in response to severe financial stress. Despite the efforts by these two states, the US suspended the provision of certain of their Compact grants in August 2008, pending the restoration of sound financial management. Fuel subsidies were raised as global oil prices surged, aggravating a shortage of public funds for essential services. Tax collections were stagnant over the year and remained low at around 12% of GDP.

The plunge in global financial markets lowered the value of the economy's Compact Trust Fund by around 20%. The Fund was established to provide the Government with revenue after the ending of current financial arrangements with the US in FY2024. More immediately, the global slowdown will damp tourism, which relies heavily on the US, Japan, and other Asian economies that are either in or close to recession. Remittances will likely take a hit because many of the overseas workers are in the US and in lower-paid jobs that are highly exposed to the downturn there. About 1,000 people are on active duty in the US Armed Forces (which compares with around 15,000 formal sector workers at home), and their steady incomes will provide a buffer against the economic downturn.

Substantial grants available from the US have the potential to provide an economic stimulus that would offset these negative external factors; at least $100 million, the equivalent of 40% of GDP, in grants allocated during FY2004–2008 remains undisbursed. However, disbursement delays are expected to persist and a further small economic contraction (0.1%) is projected for FY2009.

Correcting the poor growth performance will require strong efforts to improve budget management. The immediate priority is to accelerate

3.35.6 GDP growth, Federated States of Micronesia



Sources: Government of Federated States of Micronesia, *FY2007 Statistical Tables*, June 2008; International Monetary Fund, *Country Report No. 09/81*, March 2009.

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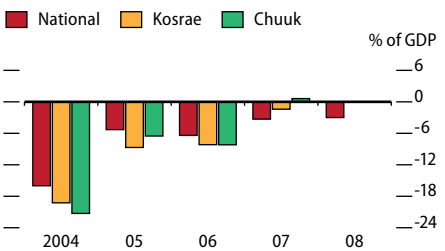
3.35.7 Fiscal balance, Federated States of Micronesia



Note: Figures for FY2008 for Chuuk and Kosrae states are not yet available.

Sources: Government of Federated States of Micronesia, *FY2007 Statistical Tables*, June 2008; International Monetary Fund, *Country Report No. 09/81*, March 2009.

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public works, and this will require timely review of bidding proposals, execution of contracts, and allocation of cofinancing needs.

Nauru

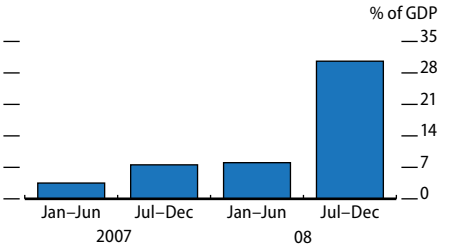
The economy expanded by an estimated 1.0% in FY2008 (ended 30 June 2008), driven by exports of phosphate. Both export volumes and prices of phosphate rose, as illustrated by a large increase in the value of Australia's imports from Nauru, which are almost entirely phosphate (Figure 3.35.8). Subtracting from growth, the Australian Government closed a refugee processing center on Nauru, which had been an important source of employment.

New phosphate contracts came into force in early 2008, locking in prices at a much higher level than previously and providing prospects of continued growth in exports. This will support modest economic growth of about 1.5% in FY2009 and FY2010.

The use of the Australian dollar as legal tender and the sourcing of about 60% of imports from Australia mean that Nauru's inflation usually tracks Australia's. In line with the Australian trend, inflation in Nauru is forecast to ease, from 4.5% in FY2008 to 3.3% in FY2009 and 2.0% in FY2010.

Primary phosphate reserves are expected to last about 5 more years, and mining has started of deeper, secondary reserves that could provide 20 years of exports worth as much as A$1 billion. The long-term economic future will depend on measures to convert this mineral wealth into alternative sources of income. The immediate challenges are to promote a performance-oriented public service, resolve a high level of public debt, and achieve good governance that can underpin sound public and private investment. The budget is expected to show a small surplus in FY2009, though in the longer term fiscal resources will be strained by a need to start repaying the large public debt.

3.35.8 Australian imports from Nauru



Source: Australian Bureau of Statistics, available: http://www.abs.gov.au, downloaded 16 February 2009.

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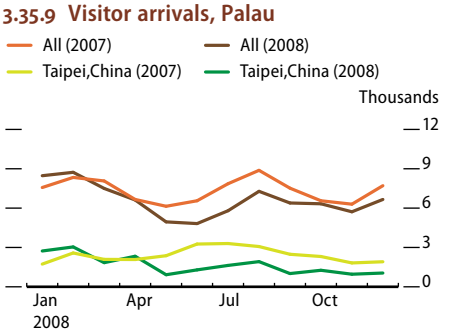
Republic of Palau

A 10.1% fall in tourist arrivals contributed to an economic contraction of about 1.0% in 2008. Monthly arrivals fell below prior-year levels during the first half of 2008 (Figure 3.35.9). One reason was the closure of a charter-flight operator from Taipei,China, the second-biggest source of visitors. An aggressive midyear marketing campaign boosted arrivals from Japan, the main source, but this only partly offset fewer arrivals from elsewhere.

Higher international commodity prices fueled inflation, which accelerated to a peak of 16.8% in the third quarter on a year-on-year basis, and averaged 12.0% over the full year (Figure 3.35.10). The cost of food rose particularly fast as global prices of rice and other grains shot up. Rising fuel costs fed into increased transport costs.

Tourism, the main driver of the economy, will likely be subdued again this year because of recessions in Japan; Taipei,China; and some other economies. The Government has begun talks with the US to renew financial assistance arrangements that end this year. (US grants account for about 20% of GDP.) Until the outcome of these talks is known,

3.35.9 Visitor arrivals, Palau



Sources: Palau Visitors Authority.

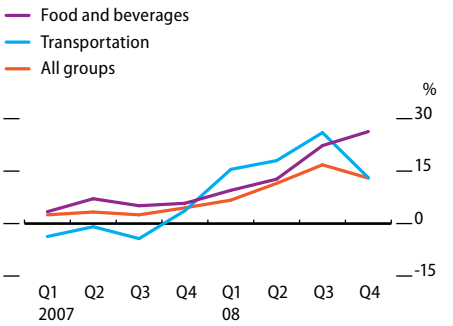
Click here for figure data

uncertainty is likely to undermine business and consumer confidence. Infrastructure spending, boosted in recent years by some large road projects, is scheduled to decline from those levels, and planned private investment in tourism facilities is likely to be delayed until tourism picks up again.

On these developments, the economy is expected to contract by about 2.0% in 2009 and by about 0.2% in 2010. Inflation is forecast to ease to 6.4% and 0.8% in these years, primarily because of lower fuel and other commodity prices.

A trust fund established with the help of the US to provide a sustainable source of funding for the Government's budget fell in value by about 28% in 2008 as global financial markets slumped. This loss in value adds to pressures to improve fiscal sustainability, by measures such as developing local revenue sources and rendering public spending more efficient. The environment for the private sector also requires attention, with the reform of state enterprises and outdated tax and foreign investment regulations a high priority.

3.35.10 Inflation, Palau



Source: Palau Office of Planning and Statistics, available: http://www.palaugov.net/stats, downloaded 11 February 2009.

Click here for figure data

Samoa

Coming off a period of fairly strong expansion in 2007, the economy grew by just 0.3% in 2008 (Figure 3.35.11). Job cutbacks at Yazaki, which assembles automotive parts for export and is the biggest private-sector employer, contributed to the slowdown. The company reduced its workforce by more than a third in 2008 and cut the working week of the remaining employees. In the 12 months to September 2008, value added in manufacturing contracted by 5.7% and in construction by 7.3%. About 3% of formal jobs were lost in the first 9 months of 2008, many from construction and manufacturing (Figure 3.35.12).

A decline in remittances from Samoans in the US outweighed a gain in remittances from Australia and New Zealand, leaving total remittances in real terms down by 4.6% in 2008 (Figure 3.35.13). Tourism receipts fell by an estimated 7.6% in real terms.

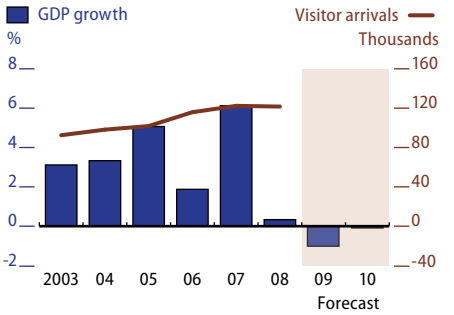
Merchandise exports dropped by 28.7% in nominal terms last year and remained a small fraction of merchandise imports, which were boosted by higher prices for imported petroleum products. The merchandise trade deficit widened from 40.5% of GDP in 2007 to about 45% in 2008. Official reserves declined to the equivalent of 4.4 months of imports at end-2008, still above the central bank's target of 4 months of imports.

Inflation accelerated to a peak of 18.7% in November 2008, year on year, driven by rising prices of food and fuel. Food was propelled by the rise in global prices, higher costs of agricultural inputs including fuel, and reduced supplies of some locally grown food. Year-average inflation at 11.5% was more than double the 2007 outcome.

The softening in the Australian and New Zealand labor markets indicates further declines in remittances. Tourism earnings, too, are expected to weaken. Further labor cutbacks at the Yazaki plant are possible if the automotive market in Australia, the main customer, remains weak.

Aggregate demand will be supported by a planned increase in public development expenditure: the overall budget deficit is expected to widen

3.35.11 GDP and visitor arrivals, Samoa



Sources: Samoa Bureau of Statistics; Central Bank of Samoa, *Selected Economic Indicators*, various issues.

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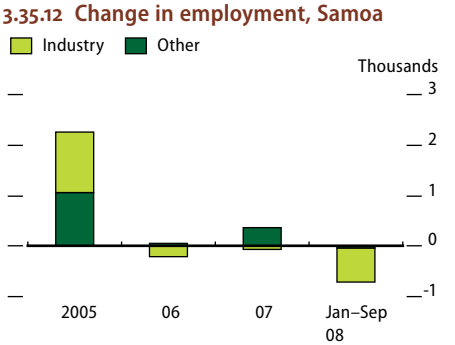
3.35.12 Change in employment, Samoa



Source: Samoa Ministry of Finance, *Quarterly Economic Review*, various issues.

Click here for figure data

from 3.2% of GDP in FY2008 (ended 30 June 2008) to 5.5% of GDP in FY2009. Still, the economy is forecast to contract by about 1.0% this year. Inflation will ease to about 7.0%, mainly the result of lower global fuel prices, which will also bring down the import bill. Official reserves should remain above the target of 4 months of imports. For the longer term, improvements in infrastructure, reform of state-owned enterprises, and facilitation of access to customary land for commercial use would help promote growth.

Solomon Islands

Economic growth remained relatively high at 6.4% in 2008, supported by the momentum generated when prices for export commodities were rising and by an expansionary fiscal policy (Figure 3.35.14). Growth was below the 10.3% seen in 2007, when high rates of logging (and 29.6% growth in log exports) accounted for an estimated one quarter of economic growth, 66% of export earnings, and 16% of government revenue from internal sources. In 2008, exports of copra, cocoa, and fish grew, but log exports declined by 5.1% in US dollar terms. The US dollar value of total merchandise exports increased by 2.8% in 2008 (Figure 3.35.15).

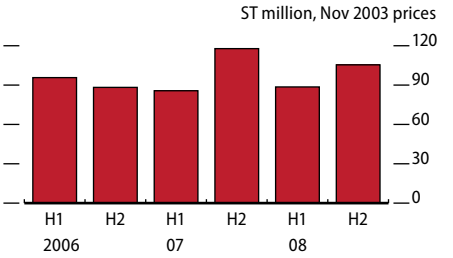
Commercial bank credit to the private sector, including that to individuals, grew by 34.3% in 2008, after growth of 50.4% in 2007. Reflecting the expansion in aggregate demand, as well as rising prices of fuel and other imported items, inflation accelerated to average 16.5%, double the rate of 2007. On a year-on-year basis, inflation peaked at 23.5% in September and ended the year at 19.3%.

Strong demand and rising costs of imports contributed to a decline in official reserves, to below the central bank's target of 3 months of import cover by year-end. The real effective exchange rate of the Solomon Islands dollar remained relatively stable.

A substantial rise in development spending and, to a lesser extent, a further increase in the Government's wage bill resulted in a budget deficit for 2008, equivalent to 5.6% of GDP (Figure 3.35.16). (The wage bill has moved up from the equivalent of 6.2% of GDP in 2004 to a budgeted 10.0% in 2009.) In 2009, the projected budget deficit of 3.6% will likely exceed funding available from cash reserves. Government borrowing to bridge the gap is ruled out under the 2005 Honiara Club agreement between the country and its official creditors. Consequently, the Government may well have to curtail public expenditure unless it can secure additional donor funding.

Logging rates have been above sustainable levels since 1992, reaching five times the sustainable rate in 2007. The commercially exploitable natural forest is expected to be fully depleted in another 4 years or so. Expected softer demand for logs from the PRC this year will translate into a reduction in logging rates. That may help the environment, but also trim economic growth. Furthermore, the planned reopening of the Gold Ridge gold mine is looking uncertain as a result of difficulties in obtaining finance. There are indications that businesses and consumers expect an economic slowdown, with the value of building works approved in the 12 months to September 2008 at a little under half the value for the year-earlier period.

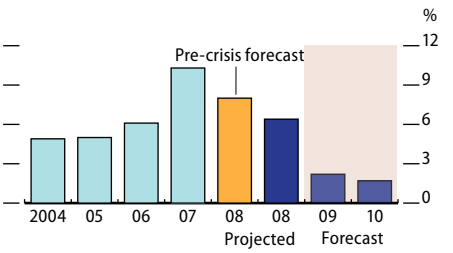
3.35.13 Remittances, Samoa



Source: Central Bank of Samoa, *Selected Economic Indicators*, various issues.

Click here for figure data

3.35.14 GDP growth, Solomon Islands



Source: Central Bank of Solomon Islands, *Quarterly Review*, September 2008.

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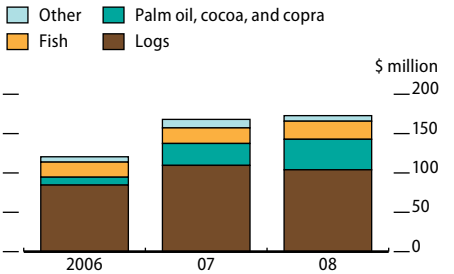
3.35.15 Merchandise exports, Solomon Islands



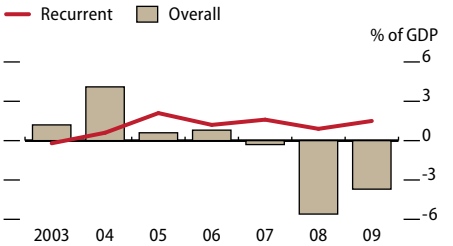
Sources: Central Bank of Solomon Islands, *Quarterly Review*, September 2008 and *Monthly Economic Bulletin*, various issues.

Click here for figure data

GDP growth is forecast to ease to 2.2% in 2009 and 1.7% in 2010 as logging exports decline. A larger than expected fall in logging rates could entail no GDP growth, and a huge widening of the current account deficit. Inflation is expected to trend down below 10% in 2009.

The central bank needs to show strong action if it is to slow the depletion in foreign reserves and maintain macroeconomic stability. The Government could assist by reducing its recurrent expenditure, particularly on wages. Additional efforts are also called for to address the structural weaknesses that threaten the sustainability of growth. Developing alternatives to logging heavily depends on improving governance, economic management, infrastructure, and the business climate.

3.35.16 Budget balance, Solomon Islands



Sources: Central Bank of Solomon Islands; Ministry of Finance, *Final Budget Strategy 2009*.

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Tonga

After an economic contraction in FY2007 (ended 30 June 2007), this economy grew by an estimated 1.2% in FY2008 (Figure 3.35.17). Reconstruction of areas damaged during civil unrest in late 2006, coupled with the building of new tourism projects, underpinned a 6.9% expansion in construction in FY2008. The transport and communications subsector grew by 5.6%, assisted by increased competition in telecommunications. Finance and real estate recorded 5.0% growth, in part reflecting higher bank lending. The expansion in these subsectors offset a 3.2% contraction in agriculture, forestry, and fishing, which was partly attributable to low prices for squash and vanilla exports, and to poor fishing conditions.

Visitor arrivals rose by 17% to 41,600, and the real value of visitor spending rose by more than 50% in FY2008. However, remittances declined slightly in real terms.

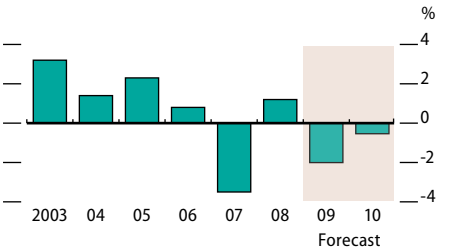
Reflecting the slight improvement in economic activity, the real value of internally raised government revenue rose by 1.8%. In contrast, the real value of expenditure and net lending fell by 7.3%. The budget surplus rose to about 2.0% of GDP.

Inflation peaked at 12.6% year on year in May 2008, before easing to 6.4% by December (Figure 3.35.18). The average inflation rate of 9.9% for FY2008 was double that of the previous year, driven by higher prices for food, fuel, transport, and electricity.

Merchandise imports, underpinned by higher costs of imported commodities, rose by 27.4% in nominal terms in FY2008. Conversely, merchandise exports (less than 10% of merchandise imports) fell by 7.0%. The trade deficit widened and official foreign reserves fell in the second half. Reserves were later bolstered by inflows of funds into the banking sector. The overall balance of payments recorded a small deficit of $1.3 million. The nominal effective exchange rate depreciated by 2.0% over the fiscal year.

Easier credit from some commercial banks in FY2008 pushed up nonperforming loans, and the banks reacted by tightening lending in the first half of FY2009. Private sector credit growth slowed to 4.3% year on year by December 2008 (Figure 3.35.19). This will put downward pressure on business investment and housing construction. An expected fall in remittances due to weaker labor markets in the US, New Zealand, and Australia will also weigh on economic growth. The real value of

3.35.17 GDP growth, Tonga

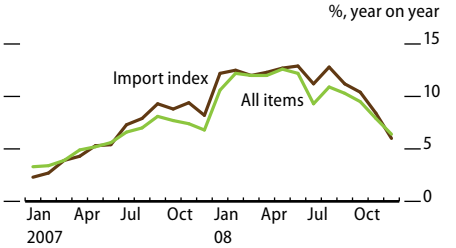


Note: Fiscal year ending June.

Source: Ministry of Finance, *Budget Statements: Review of the Tongan Economy and Outlook*, various issues.

Click here for figure data

3.35.18 Inflation, Tonga



Source: Tonga Statistics Department, *Statistical Bulletin on Consumer Price Index*, December 2008.

Click here for figure data

remittances in the first half of FY2009 fell by 18.4% from a year earlier. These negative factors are expected to see GDP contract by 2.0% in FY2009 and by 0.6% in 2010.

The PRC has offered concessionary loans for reconstruction. However, it is unclear how much of that funding the Government will draw on, given the uncertain economic outlook and conditions that tie some of the funding to purchases of goods and services from the PRC. Public expenditure is another potential source of support for the economy: the Government projects a 36.5% expansion in its spending in FY2009 (Figure 3.35.20). But funding for this expansion depends in large part on securing a 150% hike in donors' grants, a goal that looks too ambitious.

Inflation is expected to ease to 6.2% in FY 2009 as lower global commodity prices feed through into domestic prices. Lower import prices also offer some relief to the external account.

Tuvalu

Supported by a 9.8% increase in government expenditure in 2008, the economy grew by an estimated 1.5% (Figure 3.35.21). Outlays rose for public sector staffing, goods and services, and grants and subsidies. However, plans to boost capital spending were not realized, mainly because income from grants fell well short of expectations. The overall fiscal position eroded when a medical treatment plan cost four times the budgeted amount and the subsidy for the electricity utility was nearly double the budget allocation, a result of higher costs of imported fuel. The recurrent fiscal deficit was around 0.4% of GDP.

Tuvalu uses the Australian dollar as its legal tender, and inflation usually tracks that in Australia. Last year, however, inflation peaked at 13.4% in the third quarter, far above the rate in Australia, because of the economy's sensitivity to higher fuel and transportation costs.

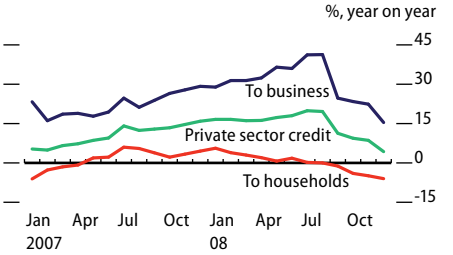
Tuvalu has a narrow economic base and produces almost no merchandise exports. It relies on external earnings to provide revenue for funding government spending. Earnings from fishing licenses increased by 18.7% last year, and remittances grew slightly. But fees from licensing the country's ".tv" Internet domain name were flat. The value of the Tuvalu Trust Fund, which is mainly invested in offshore markets, fell sharply in 2008 as a result of the global financial crisis. No distribution was therefore made from this fund to the Government's accounts.

GDP growth in 2009 and 2010 is projected to ease to about 1.0%, reflecting lower external earnings during the global economic slowdown.

Distributions from the Tuvalu Trust Fund are held in the Government's Consolidated Investment Fund. No such distributions are likely while international financial markets are depressed. This suggests the Consolidated Investment Fund will be depleted within 3 years at current government expenditure levels, even though Australia and New Zealand have committed to provide additional funding. In this context, restraints are needed on expenditure; however, the 2009 budget provides for a further increase in the wages bill and in other operating expenses.

Parliament in November 2008 approved tax and customs reforms, as well as a broad-based consumption tax to come into effect on 1 July this year. This new tax is expected both to offset the reductions in import

3.35.19 Credit growth, Tonga



Sources: National Reserve Bank of Tonga, *Quarterly Bulletin*, September 2008.

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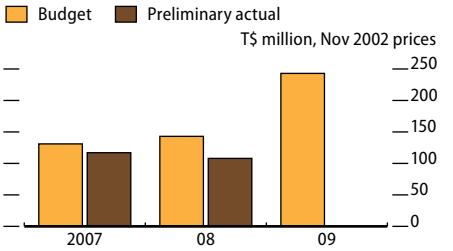
3.35.20 Real government expenditure, Tonga



Note: Fiscal year ending June.

Sources: Ministry of Finance, *Budget Statements: Review of the Tongan Economy and Outlook*, various issues.

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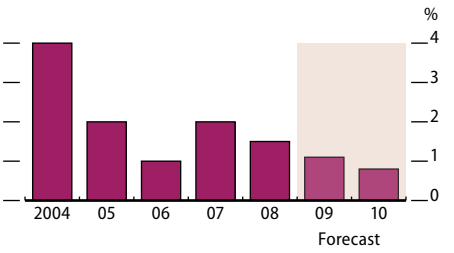
3.35.21 GDP growth, Tuvalu



Sources: Central Statistics Division, Government of Tuvalu, available: http://www.spc.int/prism/country/tv/stats/Index.htm, downloaded 9 February 2009; staff estimates.

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duties required under Tuvalu's ratification of the Pacific Island Country Trade Agreement, and to improve the tax system's efficiency and equity. Longer term, widening income disparities and the vulnerability of the low-lying atoll country to climate change are worrying.

Vanuatu

Growth in tourism and property development drove GDP growth of 6.3% in 2008, a fourth successive year of above 6% growth. Visitor arrivals grew by 13.3% in the 12 months to September 2008, with arrivals by air up by 8.0% (Figure 3.35.22). Private sector credit increased by 40.1% in the 12 months to November 2008. A 46.8% rise in the value of merchandise exports, led by copra and coconut oil, assisted the economic expansion.

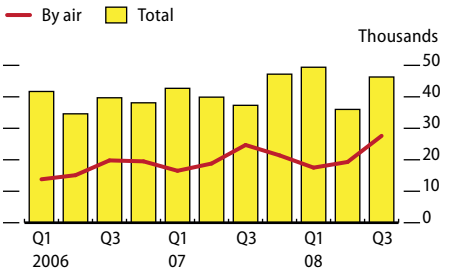
Inflation breached the Reserve Bank of Vanuatu's 0–4% target band when it hit 6.0% in the third quarter, and it averaged 5.8% for the year, according to preliminary figures. The central bank responded by raising its key policy interest rate for the first time in 2 years in September 2008. It changed tack in December 2008 as the global economic slump deepened, and relaxed bank liquid asset and reserve requirements. M2 money supply increased by 14.4% over the 12 months to November.

Merchandise imports rose by 31.0% in 2008 to reach seven times merchandise exports, pushing out the trade deficit. Still, foreign exchange reserves were at a comfortable 7.5 months of imports at year-end.

Australia accounts for more than half the visitor arrivals, so the economic slowdown there will likely crimp income from tourism this year. Also, prices for Vanuatu's agricultural exports are softening. These factors are expected to offset lower costs for imported oil and commodities, leading to a current account deficit of around 13.0% of GDP in 2009 (Figure 3.35.23). Vanuatu has relied on foreign investment inflows to finance its current account deficit, but the global crisis is likely to damp such investment this year. GDP growth is forecast to moderate to around 3.5% in 2009. Inflation is expected to ease to 3.9% because of lower prices for imported commodities, particularly fuel.

Construction funded by the US Millennium Challenge Corporation has been scaled back due to higher than expected costs, but it will still provide a much-needed boost to the country's infrastructure in the coming years. Australia and New Zealand have included Vanuatu in their programs to import labor for seasonal work. This move should, in time, help lower internal migration, the effects of which are most vividly seen in the form of urban squatter settlements and increasing numbers of urban unemployed.

3.35.22 Visitor arrivals, Vanuatu



Source: Reserve Bank of Vanuatu, *Quarterly Economic Review*, September 2008.

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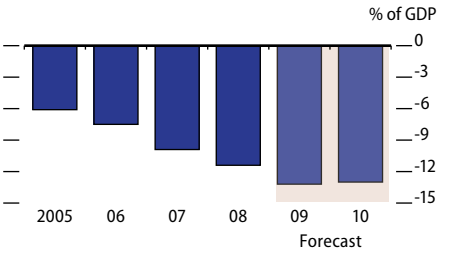
3.35.23 Current account balance, Vanuatu



Sources: International Monetary Fund, *World Economic Outlook* database; *ANZ Pacific Quarterly*, November 2008; staff estimates.

Click here for figure data

Statistical appendix

Statistical notes and tables

The statistical appendix presents selected economic indicators for 44 developing member countries of the Asian Development Bank (ADB) and for Brunei Darussalam, an unclassified regional member, in 23 tables. The economies are grouped into five subregions: Central Asia, East Asia, South Asia, Southeast Asia, and the Pacific. Most of the tables contain historical data for 2004 to 2008; some have forecasts for 2009 and 2010.

The data were standardized to the degree possible to allow comparability over time and across economies, but differences in statistical methodology, definitions, coverage, and practices make full comparability impossible. The national income accounts section is based on the United Nations System of National Accounts, while the balance of- payments data are based on International Monetary Fund (IMF) accounting standards. Historical data were obtained from official sources, statistical publications and databases, and documents of ADB, IMF, and World Bank. Projections for 2008 and 2009 are generally staff estimates made on the basis of available quarterly or monthly data, although some projections are from governments.

Most countries report on a calendar-year basis. Some economies record their government finance data on a fiscal year basis, such as: Armenia; Azerbaijan; Hong Kong, China; Cook Islands; Kazakhstan; Kyrgyz Republic; Lao People's Democratic Republic (Lao PDR); Samoa; Taipei,China; Tajikistan; Thailand; and Uzbekistan. Federated States of Micronesia; Nauru; Republic of Marshall Islands; and Republic of Palau (hereafter Palau) report government finance and balance-of-payments data on a fiscal year basis. South Asian countries (except for Maldives and Sri Lanka) and Tonga report all variables on a fiscal year basis.

Regional and subregional averages/totals are provided for nine tables (A1, A2, A8, A10, A11, A12, A13, A14, and A15). For tables A1, A2, A8, and A15, the averages are computed using weights derived from levels of gross national income (GNI) in current United States dollars (US$) following the World Bank Atlas method. The GNI data for 2004–2007 were obtained from the World Bank's World Development Indicators online. Weights for 2007 were carried over through 2010 The GNI data for Cook Islands and Tuvalu were estimated using the Atlas conversion factor. Myanmar and Nauru have no GNI data. For tables A10 and A12, the regional and subregional averages were computed on the basis of a

consistent sum, which means that if there are missing country data for a given year, the sum of the prior year used for computing the growth rate excludes the corresponding country data. Data for Myanmar and Nauru are excluded from the computation of all subregional averages/totals.

Tables A1, A2, A3, A4, A5, and A7. These tables show related data on output growth, production, and demand. Changes to the national income accounts series for some countries have been made owing to a change in source, methodology, or base year. The series for Bhutan, reflects fiscal rather than calendar year data, while those for Timor-Leste reflects non-oil, non-United Nations GDP. The constant GDP series for Lao PDR were rebased from 1990 to 2002, while those for Georgia were rebased from 1996 to 2003.

Table A1: Growth rate of GDP (% per year). The table shows annual growth rates of GDP valued at constant market prices, factor costs, or basic prices. GDP at market prices is the aggregation of the value added of all resident producers at producers' prices including taxes less subsidies on imports plus all nondeductible value-added or similar taxes. Constant factor cost measures differ from market price measures in that they exclude taxes on production and include subsidies. Basic price valuation is the factor cost plus some taxes on production, such as property and payroll taxes, and less some subsidies, such as labor-related subsidies but not product-related subsidies. Most countries use constant market price valuation. Fiji Islands, India, Pakistan, and Sri Lanka use constant factor costs, while Maldives and Nepal use basic prices.

Table A2: Growth rate of per capita GDP (% per year). The table provides the growth rates of real per capita GDP, which is defined as GDP at constant prices divided by the population. The series for most of the Pacific countries were revised due to a change in source of population data. Data on per capita gross national product in US$ terms for 2007, sourced from the World Bank, World Development Indicators online, are also shown. Per capita GNP for Cook Islands and Tuvalu are estimated based on derived GNI data.

Table A3: Growth rate of value added in agriculture (% per year). The table shows the growth rates of value added in agriculture and its corresponding share in 2007 The agriculture sector comprises agricultural crops, livestock, poultry, fisheries, and forestry.

Table A4: Growth rate of value added in industry (% per year). The table provides the growth rates of value added in industry and its corresponding share in 2007 This sector comprises manufacturing, mining and quarrying, construction, and utilities. However, construction in Uzbekistan is included in the services sector.

Table A5: Growth rate of value added in services (% per year). The table gives the growth rates of value added in services, as well as its corresponding share in 2007. Subsectors generally include trade, banking, finance, real estate, public administration, and other services.

Table A6: Unemployment rate (%). The unemployment rate is the percentage of the labor force that actively seeks work but is unable to find work at a given time. The age of the working population ranges from 15 to 65, except for Bangladesh where the labor force covers those aged 10 and above. The unemployment rates of the People's Republic of China (PRC) and Viet Nam refer to unemployment in urban areas only.

Table A7: Gross domestic investment (% of GDP). This table provides the ratio of gross domestic investment (GDI) to GDP. GDI is the sum of gross fixed capital formation plus changes in inventories. Gross fixed capital formation is measured by the total value of a producer's acquisitions, less disposals, of fixed assets in a given accounting period. Additions to the value of nonproduced assets, e.g., land, form part of gross fixed capital formation. Inventories are stocks of goods held by institutional units to meet temporary or unexpected fluctuations in production and sales. For India, GDI includes valuables and errors and omissions.

Table A8: Inflation (% per year). Data on inflation rates represent period averages. Except for India, which reports the wholesale price index, inflation rates presented are based on consumer price indexes. The consumer price indexes of the following countries are for a given city or group of consumers only: Afghanistan is for Kabul, Cambodia is for Phnom Penh, Marshall Islands is for Majuro, Solomon Islands is for Honiara, and Nepal is for urban consumers.

Table A9: Growth in money supply (% per year). This table tracks the annual percentage change in the end-of-period supply of broad money as represented by M2 (for most countries). M2 is defined as the sum of M1 and quasi-money where M1 denotes currency in circulation plus demand deposits and quasi-money consists of time and savings deposits including foreign currency deposits.

Tables A10, A12, A13, A14, A15, and A16: Balance of payments. This set of tables shows selected international economic transactions of countries as recorded in the balance of payments (BOP). These items cover annual flows, except for some countries which show data as of a specified period only. The series for Cook Islands, Fiji Islands, Kiribati, Micronesia, Papua New Guinea, and Solomon Islands have been revised due to a change in data sources.

Tables A10 and A12: Growth rates of merchandise exports and imports (% per year). The annual growth rates of exports and imports, in terms of merchandise goods only, are shown in these tables. Data are in million US$, primarily obtained from the balance-of-payments accounts of each country. Exports are reported on a free-on-board (f.o.b.) basis. Import data are generally reported on an f.o.b. basis, except for Afghanistan, Bhutan, Cambodia, India, Lao PDR, Myanmar, Philippines, Samoa, Singapore, Solomon Islands, and Thailand, which value them on a cost, insurance, freight (c.i.f.) basis.

Table A11: Direction of exports (% of total). This table shows the exports of developing Asian economies. Data are sourced from IMF, Direction of Trade and Statistics, CD-ROM (December 2008), except for Taipei,China, which were sourced from CEIC Data Company, Ltd. This table shows the percentage share of exports of each economy to other economies in developing Asia excluding the PRC; PRC only; US; Japan; European Union (EU); and others (or rest of the world). Exports to the rest of the world are derived as total exports to the world minus exports among themselves, and to US, Japan, and EU.

Table A13: Trade balance (US$ million). The trade balance is the difference between merchandise exports and merchandise imports. Figures in this table are based on the exports and imports levels used to generate Tables A10 and A12.

Table A14: Current account balance (US$ million). The current account balance is the sum of the balance of trade for merchandise, net trade in services and factor income, and net transfers. In the case of Cambodia, Lao PDR, and Viet Nam, official transfers are excluded from the current account balance.

Table A15: Current account balance (% of GDP). The values reported in Table 14 are divided by GDP at current prices in US$.

Table A16: Foreign direct investment (US$ million). Foreign direct investment refers to equity capital, reinvested earnings, investment in debt securities, and other capital associated with the transactions of the enterprises, net of repatriations and intercompany loan repayments. For the PRC, foreign direct investment refers to investments of foreign enterprises, economic organizations, and individuals through joint ventures and cooperation; reinvested earnings; and enterprises' borrowings from abroad under approved investment projects. The 2008 data for Azerbaijan and Georgia cover only the first 3 quarters of the year. The 2008 data for India is for the first 6 months of the fiscal year; while the full year figures for Tajikistan and Armenia are based on IMF estimates.

Table A17: External debt outstanding (US$ million). For most economies, external debt outstanding—public and private—includes medium- and long-term debt, short-term debt, and IMF credit. For Cambodia, Georgia, and Lao PDR, only public external debt is reported. For Azerbaijan; India; Kazakhstan; Kyrgyz Republic; Malaysia, Philippines; Singapore; and Taipei,China the figures for 2008 are as of end-September.

Table A18: Debt service ratio (% of exports of goods and services). This table generally presents the total debt service payments of each economy, which comprise principal repayments (excluding on short-term debt) and interest payments on outstanding external debt, as a percentage of exports of goods and services. For Cambodia and Lao PDR, debt service refers to external public debt only. For Papua New Guinea, Samoa, and Viet Nam, exports of goods are used as the denominator in the calculation of the ratio; for the Philippines, exports of goods, services, and income are used as the denominator. For Bangladesh, the ratio represents debt service payments on medium- and long-term loans as a percentage of exports of goods, nonfactor services, and workers' remittances; while for Azerbaijan, the ratio represents public and publicly guaranteed external debt service payments as a percentage of exports of goods and nonfactor services.

Table A19: Exchange rates to the US dollar (annual average). The annual average exchange rates of each economy are quoted in local currencies per US dollar. The rate for 2008 for India is for the period 1 April 2008–28 February 2009.

Table A20: Gross international reserves (US$ million). Gross international reserves are defined as the US$ value of holdings of foreign exchange, special drawing rights (SDR), reserve position in the IMF, and gold at the end of a given period. For Turkmenistan, gold is excluded in the computation. For Marshall Islands; Samoa; Solomon Islands; Taipei,China; Tonga; and Vanuatu, this heading refers to foreign exchange reserves only. In some countries, the rubric comprises foreign assets and reserves of national monetary authorities and national oil funds, i.e.,

foreign assets of the Maldives Monetary Authority, net foreign reserves of the State Bank of Pakistan, assets of the National Oil Fund of Azerbaijan, and official external assets of Kiribati.

Tables A21, A22, and A23: Government finance. This set of tables refers to the revenue and expenditure transactions as well as the fiscal balance of the central government expressed as a percentage of GDP in nominal terms. For Cambodia (since 2006), PRC, India, Mongolia, Kazakhstan, and Tajikistan, transactions are those reported by the general government; for Taipei,China, by the Directorate General of Budget, Accounting and Statistics. The series for Azerbaijan reflects revised data due to a change in source. For the Republic of Korea, government revenues exclude social security contributions.

Table A21: Central government expenditures (% of GDP). Central government expenditures comprise all nonrepayable payments to both current and capital expenses, plus net lending. These amounts are computed as a share of GDP at current prices. For Singapore, expenditures refer to outlays made from the Consolidated Revenue Account, Development Fund Account, and Sinking Fund Account plus lending minus repayments. For Thailand, expenditures refer to budgetary expenditures excluding externally financed expenditures and corresponding borrowing; while that for Tajikistan includes externally financed public investment programs. One-time expenditures are excluded for Pakistan.

Table A22: Central government revenues (% of GDP). Central government revenues comprise all nonrepayable receipts, both current and capital, plus grants. These amounts are computed as a percentage of GDP at current prices. For the Republic of Korea, revenues incorporate the repayment on government-guaranteed debts but exclude social security contributions. For Singapore, revenues refer to receipts credited to the three accounts listed for the previous table, including investment income, capital receipts, and investment adjustments. Grants are excluded in Cambodia, Lao PDR, Malaysia, Singapore, and Thailand; revenues from disinvestment are included for India; only current revenues are included for Bangladesh; and grants and privatization proceeds are excluded for Sri Lanka. For Cambodia, the proceeds of the IMF debt relief program are reflected in their revenues for 2006.

Table A23: Fiscal balance of central government (% of GDP). Fiscal balance is the difference between central government revenues and expenditures. The difference is also computed as a share of GDP at current prices. Data variations may arise due to statistical discrepancies, e.g., balancing items for both central and local governments, and differences in the concept used in the individual computations of revenues and expenditures as compared with the calculation of the fiscal balance. For Thailand, the fiscal balance is a cash balance composed of the budgetary and nonbudgetary balances. Some off-budget accounts are included in the computation of the fiscal balance for Turkmenistan.

Table A1 Growth rate of GDP (% per year)

	2004	2005	2006	2007	2008	2009	2010
Central Asia	9.4	11.5	13.3	12.0	5.7	3.9	4.8
Armenia	10.5	13.9	13.2	13.8	6.8	0.5	3.0
Azerbaijan	9.3	28.0	34.5	25.4	10.8	8.0	6.7
Georgia	5.9	9.4	9.2	12.4	2.0	2.5	6.0
Kazakhstan	9.6	9.7	10.7	8.9	3.2	2.0	3.3
Kyrgyz Republic	7.0	-0.2	3.1	8.5	7.6	4.0	6.0
Tajikistan	10.6	6.7	7.0	7.8	7.9	3.0	4.0
Turkmenistan	14.7	13.0	11.4	11.6	10.5	10.0	10.0
Uzbekistan	7.7	7.0	7.2	9.5	8.5	7.0	6.5
East Asia	8.4	8.3	9.4	10.4	6.6	3.6	6.5
China, People's Rep. of	10.1	10.4	11.6	13.0	9.0	7.0	8.0
Hong Kong, China	8.5	7.1	7.0	6.4	2.5	-2.0	3.0
Korea, Rep. of	4.7	4.2	5.1	5.0	2.5	-3.0	4.0
Mongolia	10.6	7.3	8.6	10.2	8.9	3.0	4.5
Taipei,China	6.2	4.2	4.8	5.7	0.1	-4.0	2.4
South Asia	7.3	9.1	9.0	8.6	6.8	4.8	6.1
Afghanistan, Islamic Rep. of	8.0	16.1	8.2	12.1	3.4	9.0	7.5
Bangladesh	6.3	6.0	6.6	6.4	6.2	5.6	5.2
Bhutan	7.0	6.6	6.4	14.1	11.5	5.5	6.5
India	7.5	9.5	9.7	9.0	7.1	5.0	6.5
Maldives	9.5	-4.6	18.0	7.2	5.7	1.0	1.5
Nepal	4.4	3.2	3.7	2.7	5.3	3.0	3.5
Pakistan	7.5	9.0	5.8	6.8	5.8	2.8	4.0
Sri Lanka	5.4	6.2	7.7	6.8	6.0	4.5	6.0
Southeast Asia	6.5	5.7	6.0	6.4	4.3	0.7	4.2
Brunei Darussalam	0.5	0.4	4.4	0.6	-2.7	-0.4	2.3
Cambodia	10.3	13.3	10.8	10.2	6.5	2.5	4.0
Indonesia	5.0	5.7	5.5	6.3	6.1	3.6	5.0
Lao People's Dem. Rep.	7.0	6.8	8.3	7.8	7.2	5.5	5.7
Malaysia	6.8	5.3	5.8	6.3	4.6	-0.2	4.4
Myanmar	13.6	13.6	13.1	11.9	-	-	-
Philippines	6.4	5.0	5.4	7.2	4.6	2.5	3.5
Singapore	9.3	7.3	8.4	7.8	1.1	-5.0	3.5
Thailand	6.3	4.6	5.2	4.9	2.6	-2.0	3.0
Viet Nam	7.8	8.4	8.2	8.5	6.2	4.5	6.5
The Pacific	3.8	2.9	2.0	2.8	5.1	3.0	2.7
Cook Islands	4.3	0.0	0.7	1.3	1.1	1.0	0.8
Fiji Islands	5.5	0.6	3.4	-6.6	1.2	-0.5	0.2
Kiribati	-1.7	1.6	-5.2	0.5	0.6	1.0	0.9
Marshall Islands, Rep. of	6.7	2.0	0.9	1.3	1.5	0.5	0.8
Micronesia, Fed. States of	-3.3	-0.6	-2.3	-3.1	-1.0	-0.1	0.8
Nauru	-	-14.5	6.3	-27.3	1.0	1.5	1.5
Palau, Rep. of	6.0	5.9	4.8	2.1	-1.0	-2.0	-0.2
Papua New Guinea	2.7	3.6	2.6	6.5	7.2	4.0	3.5
Samoa	3.3	4.0	1.9	5.5	0.3	-1.0	-0.1
Solomon Islands	8.0	5.0	6.1	10.3	6.4	2.2	1.7
Timor-Leste, Dem. Rep. of	4.1	6.2	-5.8	8.0	10.0	10.0	8.0
Tonga	1.4	2.3	0.8	-3.5	1.2	-2.0	-0.6
Tuvalu	4.0	2.0	1.0	2.0	1.5	1.0	0.9
Vanuatu	5.5	6.5	7.2	6.8	6.3	3.5	0.8
Average	7.9	8.1	8.9	9.5	6.3	3.4	6.0

- = not available.

Table A2 Growth rate of per capita GDP (% per year)

	2004	2005	2006	2007	2008	2009	2010	Per capita GNP, US$, 2007
Central Asia	8.6	10.4	12.0	10.8	4.8	3.2	4.0	
Armenia	10.4	11.9	15.0	13.7	6.5	0.7	3.2	2,640
Azerbaijan	8.4	26.7	31.6	24.0	9.7	7.0	5.5	2,250
Georgia	6.5	9.2	7.2	12.9	2.8	2.5	6.0	2,120
Kazakhstan	9.0	8.8	9.6	7.6	2.5	1.3	2.6	5,060
Kyrgyz Republic	5.9	-1.1	2.1	7.3	6.4	2.8	4.8	590
Tajikistan	8.3	4.5	5.4	6.3	6.4	1.5	2.5	460
Turkmenistan	12.9	11.2	9.7	10.1	8.4	8.4	8.3	-
Uzbekistan	6.5	5.8	6.0	7.9	7.3	6.2	6.1	730
East Asia	7.8	7.6	8.3	9.9	6.1	3.0	6.0	
China, People's Rep. of	9.4	9.6	10.2	12.4	8.4	6.3	7.4	2,360
Hong Kong, China	7.6	6.6	6.3	5.3	1.7	-2.7	2.3	31,610
Korea, Rep. of	4.3	4.0	4.8	4.6	2.2	-3.3	3.7	19,690
Mongolia	9.4	6.0	7.3	8.7	7.0	1.7	3.1	1,290
Taipei,China	5.8	3.8	4.3	5.3	-0.2	-4.4	2.0	17,931
South Asia	5.7	7.5	7.4	7.0	5.3	3.3	4.6	
Afghanistan, Islamic Rep. of	5.8	13.7	6.0	9.8	1.3	6.8	5.4	-
Bangladesh	4.9	4.6	5.2	5.1	4.9	4.2	3.8	470
Bhutan	5.6	5.3	5.0	12.5	9.9	4.0	2.1	1,770
India	5.8	7.9	8.2	7.5	5.6	3.5	5.0	950
Maldives	8.0	-6.2	15.3	5.7	4.1	-0.6	-0.1	3,200
Nepal	2.1	0.9	1.5	0.8	2.7	1.0	1.5	340
Pakistan	6.5	6.5	3.9	5.3	4.3	1.2	2.3	870
Sri Lanka	4.3	5.1	6.5	6.1	4.9	3.5	5.0	1,540
Southeast Asia	5.0	3.7	4.5	4.6	2.4	-0.8	2.6	
Brunei Darussalam	-2.3	-2.4	0.9	-1.2	-4.7	-2.1	1.5	26,930
Cambodia	8.5	11.0	8.2	7.8	4.9	0.4	1.9	540
Indonesia	3.7	3.4	4.8	4.9	4.7	2.2	3.6	1,650
Lao People's Dem. Rep.	4.1	-1.9	6.0	6.3	5.3	3.6	4.0	580
Malaysia	4.6	3.1	3.7	4.3	2.6	-2.2	2.3	6,540
Myanmar	11.3	13.6	10.8	11.0	-	-	-	-
Philippines	4.2	2.9	3.3	5.1	2.6	0.5	1.5	1,620
Singapore	7.9	4.8	5.0	3.4	-4.1	-8.4	-0.2	32,470
Thailand	5.4	3.7	4.5	4.2	1.9	-2.1	2.9	3,400
Viet Nam	6.3	7.0	6.9	7.2	4.8	3.2	5.1	790
The Pacific	1.9	0.8	-0.5	1.1	3.3	1.2	0.9	
Cook Islands	-5.4	0.5	-2.2	0.3	1.1	-1.8	-2.0	-
Fiji Islands	4.8	0.2	2.8	-7.1	0.7	-1.2	-0.5	3,800
Kiribati	-3.5	-0.7	-6.9	-1.3	-0.8	-0.8	-	1,170
Marshall Islands, Rep. of	5.6	0.5	0.2	0.6	0.5	-0.8	-0.5	3,070
Micronesia, Fed. States of	-3.4	-0.7	-2.4	-3.2	-1.0	-0.1	0.9	2,470
Nauru	-	-12.7	8.8	-28.4	-1.1	-0.5	-0.5	-
Palau, Rep. of	5.2	5.0	4.1	1.3	-1.6	-2.6	-0.8	8,210
Papua New Guinea	0.1	0.8	-1.7	4.3	5.0	1.9	1.4	850
Samoa	2.9	3.5	1.5	5.1	-0.1	-1.4	-0.5	2,430
Solomon Islands	5.1	2.1	3.2	7.3	3.5	-0.4	-0.9	730
Timor-Leste, Dem. Rep. of	2.0	-0.3	-8.8	4.6	6.6	6.7	4.8	1,510
Tonga	1.1	2.0	0.5	-3.8	0.8	-2.4	-1.0	2,320
Tuvalu	3.5	1.5	0.5	1.5	1.2	0.7	0.6	-
Vanuatu	2.9	3.9	4.6	4.2	3.6	1.0	-1.7	1,840
Average	7.0	7.0	7.6	8.6	5.4	2.5	5.1	

- = not available.

Table A3 Growth rate of value added in agriculture (% per year)

	2004	2005	2006	2007	2008	Sector share 2007, %
Central Asia						
Armenia	14.2	11.2	0.5	10.2	1.3	20.1
Azerbaijan	5.0	7.4	1.0	4.0	7.0	6.0
Georgia	-7.9	12.0	-11.7	3.3	-	12.7
Kazakhstan	-0.1	7.1	6.0	8.9	-5.6	7.9
Kyrgyz Republic	4.1	-4.2	1.7	1.6	0.7	30.7
Tajikistan	-	-	-	-	-	-
Turkmenistan	-	-	-	-	-	-
Uzbekistan	10.1	5.6	6.2	6.1	4.0	34.4
East Asia						
China, People's Rep. of	6.3	5.2	5.0	3.7	5.5	9.7
Hong Kong, China	2.7	-1.0	-4.9	-6.4	-15.0	0.1
Korea, Rep. of	9.2	0.7	-1.5	1.1	3.5	3.6
Mongolia	15.8	10.7	7.5	15.8	5.0	26.0
Taipei,China	-4.1	-8.1	6.1	-1.9	-1.4	1.3
South Asia						
Afghanistan, Islamic Rep. of	-17.1	-	-	-	-	-
Bangladesh	4.1	2.2	4.9	4.6	3.6	21.4
Bhutan	2.0	1.1	1.2	1.2	2.0	19.4
India	0.0	5.8	4.0	4.9	2.6	17.8
Maldives	2.9	11.8	-0.3	-14.9	-1.4	6.9
Nepal	4.8	3.5	1.8	1.0	4.7	35.9
Pakistan	2.4	6.5	6.3	3.7	1.5	21.8
Sri Lanka	0.0	1.8	6.3	3.4	7.5	11.9
Southeast Asia						
Brunei Darussalam	12.0	1.2	-9.8	-4.5	1.0	1.1
Cambodia	-0.9	15.7	5.5	5.0	4.5	28.7
Indonesia	2.8	2.7	3.4	3.4	4.8	13.8
Lao People's Dem. Rep.	3.4	0.7	2.9	8.6	2.0	36.2
Malaysia	4.7	2.6	5.4	2.2	3.8	7.4
Myanmar	11.0	13.6	9.7	8.0	-	43.7
Philippines	5.2	2.0	3.7	4.9	3.2	18.4
Singapore	12.7	-1.2	15.5	-3.0	-4.0	0.1
Thailand	-2.4	-1.8	4.6	1.8	5.1	8.7
Viet Nam	4.4	4.0	3.7	3.4	3.8	17.9
The Pacific						
Cook Islands	-2.6	-3.5	-4.6	8.4	-	14.0
Fiji Islands	5.2	0.9	-0.5	-5.7	1.2	14.4
Kiribati	-84.6	-63.3	-658.4	-	-	-
Marshall Islands, Rep. of	4.5	0.2	10.2	-	-	-
Micronesia, Fed. States of	-2.2	-1.2	-2.3	-2.0	-	18.8
Nauru	-	-	-	-	-	-
Palau, Rep. of	2.9	12.6	2.9	2.7	-	3.5
Papua New Guinea	4.6	2.4	0.8	3.8	5.0	37.0
Samoa	-6.9	4.8	-4.1	9.4	-	12.1
Solomon Islands	20.3	2.9	3.2	-	-	-
Timor-Leste, Dem. Rep. of	6.0	6.3	0.3	-5.6	-	31.2
Tonga	0.3	-3.7	1.6	-0.9	-	25.3
Tuvalu	-	-	-	-	-	-
Vanuatu	7.2	-4.4	2.4	-	-	-

- = not available.

Table A4 Growth rate of value added in industry (% per year)

	2004	2005	2006	2007	2008	Sector share 2007, %
Central Asia						
Armenia	8.1	14.8	16.6	12.1	5.4	44.6
Azerbaijan	9.9	46.1	49.8	33.1	18.0	73.6
Georgia	12.1	12.0	13.5	14.5	-	27.6
Kazakhstan	11.2	10.7	13.4	8.0	2.4	36.5
Kyrgyz Republic	3.0	-9.8	-6.9	10.3	10.7	20.4
Tajikistan	-	-	-	-	-	-
Turkmenistan	-	-	-	-	-	-
Uzbekistan	5.0	8.9	7.4	8.3	12.0	36.0
East Asia						
China, People's Rep. of	11.1	11.7	13.0	14.7	9.3	59.0
Hong Kong, China	-2.4	-1.4	-2.1	-0.5	-1.9	8.2
Korea, Rep. of	8.8	5.7	6.6	5.5	2.5	44.4
Mongolia	18.3	5.2	6.9	7.0	0.8	33.3
Taipei,China	8.9	6.3	6.8	9.3	-1.2	31.4
South Asia						
Afghanistan, Islamic Rep. of	32.4	-	-	-	-	-
Bangladesh	7.6	8.3	9.7	8.4	6.9	29.4
Bhutan	5.8	3.5	5.5	30.6	19.2	42.9
India	10.3	10.2	11.0	8.1	4.8	26.5
Maldives	12.9	2.9	15.8	10.0	6.9	16.8
Nepal	1.4	3.0	4.5	3.9	1.9	16.9
Pakistan	16.3	12.1	4.1	8.0	4.6	26.1
Sri Lanka	5.4	8.0	8.1	7.6	5.9	28.5
Southeast Asia						
Brunei Darussalam	-0.5	-1.8	2.9	-5.6	-4.5	56.6
Cambodia	16.6	12.7	18.3	8.4	7.1	30.2
Indonesia	3.9	4.7	4.5	4.7	3.7	43.0
Lao People's Dem. Rep.	3.7	10.6	17.1	4.4	10.2	22.7
Malaysia	7.4	3.4	4.4	3.2	0.9	40.5
Myanmar	21.4	19.9	20.0	19.6	-	19.8
Philippines	5.2	3.8	4.8	7.1	5.0	32.5
Singapore	10.5	8.1	10.6	7.2	-1.0	31.8
Thailand	7.9	5.4	5.7	5.7	3.4	47.5
Viet Nam	10.2	10.7	10.4	10.6	6.3	41.8
The Pacific						
Cook Islands	10.6	-12.3	1.5	7.5	-	9.2
Fiji Islands	10.0	-6.6	2.5	-6.9	1.4	23.9
Kiribati	2.4	10.2	2.2	-	-	-
Marshall Islands, Rep. of	4.5	0.2	-5.6	-	-	-
Micronesia, Fed. States of	1.0	-1.2	-2.3	-7.7	-	5.3
Nauru	-	-	-	-	-	-
Palau, Rep. of	10.2	-3.6	12.7	19.8	-	20.7
Papua New Guinea	1.9	6.0	3.2	7.6	7.8	34.1
Samoa	5.4	3.1	-1.4	8.6	-	26.6
Solomon Islands	1.3	9.2	3.4	-	-	-
Timor-Leste, Dem. Rep. of	-0.7	10.6	-18.1	28.7	-	16.6
Tonga	-0.3	-6.7	-2.1	-5.9	-	13.5
Tuvalu	-	-	-	-	-	-
Vanuatu	5.4	7.1	7.1	-	-	-

- = not available.

Table A5 Growth rate of value added in services (% per year)

	2004	2005	2006	2007	2008	Sector share 2007, %
Central Asia						
Armenia	13.1	14.7	15.5	13.3	9.0	35.3
Azerbaijan	9.5	9.4	17.4	12.8	13.7	20.4
Georgia	7.7	8.6	14.5	13.0	-	59.7
Kazakhstan	10.8	10.4	10.9	9.4	5.0	55.5
Kyrgyz Republic	11.9	8.4	9.0	12.6	10.7	48.9
Tajikistan	-	-	-	-	-	-
Turkmenistan	-	-	-	-	-	-
Uzbekistan	7.4	7.1	8.8	17.4	13.5	29.5
East Asia						
China, People's Rep. of	10.1	10.5	12.1	13.8	9.5	31.4
Hong Kong, China	9.9	7.5	7.1	7.0	2.5	91.7
Korea, Rep. of	1.9	3.4	4.2	4.8	2.3	52.0
Mongolia	1.0	9.0	6.1	10.7	15.9	40.7
Taipei,China	5.3	3.5	3.9	4.3	0.8	67.2
South Asia						
Afghanistan, Islamic Rep. of	34.6	-	-	-	-	-
Bangladesh	5.7	6.4	6.4	6.9	6.7	49.2
Bhutan	10.3	13.3	11.4	7.3	8.7	37.7
India	9.1	10.6	11.2	10.9	9.6	55.7
Maldives	9.7	-8.2	21.3	9.1	6.0	76.3
Nepal	6.8	3.3	5.6	4.5	7.0	47.3
Pakistan	5.8	8.5	6.5	7.6	8.2	52.1
Sri Lanka	6.7	6.4	7.7	7.1	5.6	59.6
Southeast Asia						
Brunei Darussalam	2.0	4.1	7.4	10.4	-0.4	42.4
Cambodia	13.2	13.1	10.1	10.1	8.5	41.1
Indonesia	7.1	7.9	7.3	8.8	8.9	43.1
Lao People's Dem. Rep.	12.0	9.9	7.4	9.1	9.7	41.2
Malaysia	6.4	7.2	7.3	9.7	7.3	52.1
Myanmar	14.4	13.1	14.2	12.9	-	36.5
Philippines	7.7	7.0	6.5	8.1	4.9	49.1
Singapore	8.1	6.8	7.4	7.7	4.5	68.1
Thailand	6.8	5.2	4.9	4.7	1.2	43.8
Viet Nam	7.3	8.5	8.3	8.7	7.2	40.4
The Pacific						
Cook Islands	4.8	2.3	1.5	-0.7	-	76.8
Fiji Islands	3.7	5.0	6.0	-6.8	0.6	61.7
Kiribati	2.3	5.0	5.9	-	-	-
Marshall Islands, Rep. of	4.5	2.5	3.0	-	-	-
Micronesia, Fed. States of	-3.8	-0.4	-2.3	-1.3	-	75.9
Nauru	-	-	-	-	-	-
Palau, Rep. of	5.3	7.8	0.8	-1.5	-	75.8
Papua New Guinea	-0.7	2.9	4.5	9.4	9.2	28.9
Samoa	4.8	4.3	4.5	3.5	-	62.5
Solomon Islands	1.5	0.3	7.5	-	-	-
Timor-Leste, Dem. Rep. of	4.4	4.9	-5.9	11.9	-	52.2
Tonga	2.3	-2.6	7.1	1.9	-	61.2
Tuvalu	-	-	-	-	-	-
Vanuatu	5.0	9.4	8.4	-	-	-

- = not available.

Table A6 Unemployment rate (%)

	2004	2005	2006	2007	2008
Central Asia					
Armenia	9.6	8.1	7.4	7.1	6.3
Azerbaijan	1.4	1.4	1.3	1.5	1.5
Georgia	12.6	13.8	13.6	13.3	-
Kazakhstan	9.2	8.7	7.2	6.6	6.1
Kyrgyz Republic	8.5	8.1	8.3	8.2	-
Tajikistan	2.0	2.0	2.3	2.6	-
Turkmenistan	4.2	-	-	-	-
Uzbekistan	0.2	0.3	-	-	-
East Asia					
China, People's Rep. of	4.2	4.2	4.1	4.0	4.2
Hong Kong, China	6.8	5.6	4.8	4.0	3.5
Korea, Rep. of	3.7	3.7	3.5	3.2	3.2
Mongolia	3.6	3.3	3.2	3.0	3.0
Taipei,China	5.0	4.4	4.1	3.9	5.0
South Asia					
Afghanistan, Islamic Rep. of	3.4	-	-	-	-
Bangladesh	-	4.6	-	-	-
Bhutan	2.5	3.1	3.2	3.7	-
India	-	-	-	-	-
Maldives	-	-	-	-	-
Nepal	-	-	-	-	-
Pakistan	7.7	7.7	6.2	5.3	-
Sri Lanka	8.3	7.7	6.5	6.0	5.2
Southeast Asia					
Brunei Darussalam	3.5	4.3	4.0	3.4	3.7
Cambodia	-	-	-	-	-
Indonesia	9.9	11.2	10.3	9.1	8.4
Lao People's Dem. Rep.	-	-	-	-	-
Malaysia	3.5	3.5	3.4	3.0	-
Myanmar	-	-	-	-	-
Philippines	11.8	11.5	8.0	7.3	7.4
Singapore	4.4	3.1	3.4	2.9	2.8
Thailand	2.1	1.8	1.5	1.4	1.4
Viet Nam	5.6	5.3	4.8	4.6	4.7
The Pacific					
Cook Islands	-	-	-	-	-
Fiji Islands	5.8	5.9	6.4	6.9	-
Kiribati	-	6.1	-	-	-
Marshall Islands, Rep. of	30.9	30.9	30.9	30.9	-
Micronesia, Fed. States of	-	-	-	-	-
Nauru	-	-	-	-	-
Palau, Rep. of	-	-	-	-	-
Papua New Guinea	-	-	-	-	-
Samoa	1.8	-	4.0	-	-
Solomon Islands	-	-	-	-	-
Timor-Leste, Dem. Rep. of	-	-	-	-	-
Tonga	-	-	-	-	-
Tuvalu	-	-	-	-	-
Vanuatu	-	-	-	-	-

- = not available.

Table A7 Gross domestic investment (% of GDP)

	2004	2005	2006	2007	2008
Central Asia					
Armenia	24.9	30.5	35.9	43.7	-
Azerbaijan	58.0	41.5	29.9	21.3	18.8
Georgia	31.9	33.5	30.9	32.1	20.0
Kazakhstan	26.3	31.0	33.9	35.6	-
Kyrgyz Republic	14.5	16.4	24.2	26.6	22.5
Tajikistan	19.7	13.1	-	-	-
Turkmenistan	23.4	23.0	23.9	-	-
Uzbekistan	23.9	23.0	-	-	-
East Asia					
China, People's Rep. of	43.3	44.0	44.5	43.3	42.9
Hong Kong, China	21.8	20.6	21.7	20.9	20.2
Korea, Rep. of	30.4	30.1	29.9	29.4	-
Mongolia	34.6	36.9	35.1	40.3	-
Taipei,China	22.7	21.4	21.5	21.5	21.2
South Asia					
Afghanistan, Islamic Rep. of	41.9	44.6	42.0	36.7	32.0
Bangladesh	24.0	24.5	24.7	24.5	24.2
Bhutan	64.8	54.3	49.0	-	-
India	32.2	35.5	36.4	38.7	40.1
Maldives	36.0	-	-	-	-
Nepal	24.5	26.5	26.9	28.1	31.8
Pakistan	16.6	19.1	22.1	22.9	21.6
Sri Lanka	25.3	26.8	28.0	27.9	29.2
Southeast Asia					
Brunei Darussalam	13.5	11.4	10.4	12.9	12.2
Cambodia	16.2	18.5	20.6	20.8	-
Indonesia	24.1	25.1	25.4	24.9	27.8
Lao People's Dem. Rep.	-	-	-	-	-
Malaysia	23.0	20.0	20.9	21.9	19.1
Myanmar	12.0	13.2	13.7	15.0	-
Philippines	16.7	14.6	14.5	15.3	15.3
Singapore	21.8	20.2	20.1	20.7	30.9
Thailand	26.8	31.4	28.4	26.6	28.8
Viet Nam	35.5	35.6	36.8	41.6	38.7
The Pacific					
Cook Islands	-	-	-	-	-
Fiji Islands	19.2	19.0	-	-	-
Kiribati	-	-	-	-	-
Marshall Islands, Rep. of	56.5	56.9	57.0	-	-
Micronesia, Fed. States of	38.1	38.0	38.0	73.2	-
Nauru	-	-	-	-	-
Palau, Rep. of	-	-	-	-	-
Papua New Guinea	-	-	-	-	-
Samoa	-	-	-	-	-
Solomon Islands	-	-	-	-	-
Timor-Leste, Dem. Rep. of	22.7	21.9	22.5	32.9	-
Tonga	17.9	18.1	16.7	-	-
Tuvalu	-	-	-	-	-
Vanuatu	21.2	21.5	23.9	-	-

- = not available.

Table A8 Inflation (% per year)

	2004	2005	2006	2007	2008	2009	2010
Central Asia	6.6	8.0	9.0	11.2	16.2	10.6	7.8
Armenia	7.0	0.6	2.9	4.4	9.0	7.5	7.5
Azerbaijan	6.7	9.6	8.3	16.7	20.8	12.0	7.0
Georgia	5.7	8.3	9.2	9.2	10.0	7.0	7.5
Kazakhstan	6.9	7.6	8.6	10.8	17.3	10.0	6.4
Kyrgyz Republic	4.1	4.4	5.6	10.2	24.5	15.0	12.0
Tajikistan	7.2	7.3	10.0	13.2	20.7	15.5	9.5
Turkmenistan	5.9	10.7	8.2	6.3	8.9	12.0	10.0
Uzbekistan	6.6	10.2	14.3	12.3	13.0	12.5	13.0
East Asia	3.3	2.0	1.6	3.9	5.4	1.1	1.3
China, People's Rep. of	3.9	1.8	1.5	4.8	5.9	0.8	1.0
Hong Kong, China	-0.4	0.9	2.0	2.0	4.3	1.5	2.0
Korea, Rep. of	3.6	2.8	2.2	2.5	4.7	2.0	2.0
Mongolia	8.2	12.7	5.1	7.5	26.8	9.5	8.0
Taipei,China	1.6	2.3	0.6	1.8	3.5	0.6	1.2
South Asia	6.2	5.3	5.9	5.5	9.6	5.6	4.4
Afghanistan, Islamic Rep. of	-	12.3	5.3	12.9	28.3	6.0	6.8
Bangladesh	5.8	6.5	7.2	7.2	9.9	7.0	6.5
Bhutan	3.6	4.8	4.9	5.2	6.4	3.5	4.0
India	6.4	4.4	5.4	4.7	8.7	3.5	4.0
Maldives	6.4	3.3	3.5	7.4	12.3	4.5	5.5
Nepal	4.0	4.5	8.0	6.4	7.7	10.0	8.0
Pakistan	4.6	9.3	7.9	7.8	12.0	20.0	6.0
Sri Lanka	9.0	11.0	10.0	15.8	22.6	8.0	6.0
Southeast Asia	4.1	6.3	7.1	4.0	8.8	3.3	4.1
Brunei Darussalam	0.9	1.2	0.2	0.3	2.7	1.5	1.2
Cambodia	3.8	5.9	4.7	5.9	19.7	7.0	4.3
Indonesia	6.1	10.5	13.1	6.4	10.3	6.3	6.9
Lao People's Dem. Rep.	10.5	7.2	6.9	4.5	7.6	5.0	6.0
Malaysia	1.4	3.1	3.6	2.0	5.4	1.5	2.4
Myanmar	3.8	10.7	26.3	32.9	26.4	-	-
Philippines	6.0	7.6	6.2	2.8	9.3	4.5	5.0
Singapore	1.7	0.5	1.0	2.1	6.5	0.5	2.0
Thailand	2.8	4.5	4.6	2.3	5.5	0.5	1.5
Viet Nam	7.7	8.3	7.5	8.3	23.0	4.0	5.0
The Pacific	3.1	2.5	3.0	3.6	9.6	6.2	4.9
Cook Islands	0.9	2.5	3.4	2.5	7.8	5.1	2.4
Fiji Islands	2.8	2.4	2.5	4.8	7.7	4.5	4.5
Kiribati	-0.7	-0.4	-1.5	4.2	11.0	6.5	2.0
Marshall Islands, Rep. of	2.2	4.4	4.3	3.1	17.5	9.2	0.8
Micronesia, Fed. States of	1.8	4.2	4.4	2.8	5.0	2.9	0.8
Nauru	2.3	2.7	3.5	2.3	4.5	3.3	2.0
Palau, Rep. of	5.0	3.9	4.5	3.2	12.0	6.4	0.8
Papua New Guinea	2.1	1.8	2.4	0.9	10.8	7.0	6.0
Samoa	16.3	1.9	3.8	5.5	11.5	7.0	2.4
Solomon Islands	6.9	7.3	8.4	7.6	16.5	8.6	2.0
Timor-Leste, Dem. Rep. of	0.8	1.8	4.0	8.9	7.6	7.1	6.5
Tonga	11.8	10.0	7.2	5.1	9.9	6.2	2.4
Tuvalu	2.8	3.2	3.8	2.2	5.3	3.7	2.0
Vanuatu	0.8	1.8	1.7	4.1	5.8	3.9	2.0
Average	4.0	3.4	3.3	4.4	6.9	2.4	2.4

- = not available.

Table A9 Change in money supply (% per year)

	2004	2005	2006	2007	2008
Central Asia					
Armenia	22.3	27.8	32.9	42.3	2.4
Azerbaijan	47.5	22.5	86.8	71.4	44.0
Georgia	42.4	26.5	39.7	49.7	6.9
Kazakhstan	69.8	25.2	78.1	25.9	35.3
Kyrgyz Republic	32.0	9.9	51.6	33.3	12.6
Tajikistan	51.6	30.2	63.3	78.8	33.1
Turkmenistan	12.7	27.9	55.9	40.4	43.0
Uzbekistan	47.8	54.3	36.8	46.2	32.4
East Asia					
China, People's Rep. of	14.9	16.3	17.0	16.7	17.8
Hong Kong, China	9.3	5.1	15.4	20.8	2.7
Korea, Rep. of	6.3	7.0	12.5	10.8	12.0
Mongolia	20.4	34.6	34.8	56.3	-3.4
Taipei,China	7.4	6.6	5.3	0.9	7.0
South Asia					
Afghanistan, Islamic Rep. of	31.9	12.1	22.3	14.4	34.6
Bangladesh	13.8	16.8	19.5	16.8	17.6
Bhutan	4.0	10.7	41.4	8.6	2.3
India	12.3	21.2	21.5	20.7	-
Maldives	32.7	11.7	20.6	23.7	23.6
Nepal	12.8	8.3	15.4	14.0	25.2
Pakistan	19.6	19.3	14.9	19.3	15.3
Sri Lanka	19.6	19.1	17.8	16.6	8.5
Southeast Asia					
Brunei Darussalam	17.4	6.8	-3.9	4.6	-1.3
Cambodia	30.0	16.1	38.2	62.9	2.3
Indonesia	8.1	16.4	14.9	18.9	14.6
Lao People's Dem. Rep.	22.3	8.2	30.1	38.7	10.4
Malaysia	25.2	15.6	17.1	9.5	13.4
Myanmar	33.3	25.1	27.1	20.9	-
Philippines	10.3	10.3	22.7	10.6	15.6
Singapore	6.2	6.2	19.4	13.4	12.0
Thailand	5.8	6.1	8.2	6.3	9.1
Viet Nam	29.5	29.7	33.6	46.1	20.3
The Pacific					
Cook Islands	9.2	-5.0	22.5	-5.8	4.0
Fiji Islands	10.4	15.0	19.8	10.4	-6.9
Kiribati	-	-	-	-	-
Marshall Islands, Rep. of	15.4	14.9	-	-	-
Micronesia, Fed. States of	-0.1	1.6	-8.5	4.6	-
Nauru	-	-	-	-	-
Palau, Rep. of	-	-	-	-	-
Papua New Guinea	14.8	29.5	38.9	27.8	11.2
Samoa	8.3	15.7	13.7	11.0	5.8
Solomon Islands	19.5	38.9	26.4	24.0	7.5
Timor-Leste, Dem. Rep. of	48.3	26.3	8.6	0.9	33.1
Tonga	18.6	12.1	14.4	14.1	8.3
Tuvalu	-	-	-	-	-
Vanuatu	9.8	11.6	7.0	16.1	14.4

- = not available.

Table A10 Growth rate of merchandise exports (% per year)

	2004	2005	2006	2007	2008	2009	2010
Central Asia	41.2	36.1	39.3	34.0	49.2	-36.9	18.1
Armenia	6.1	36.1	2.0	16.7	-7.2	-2.0	4.0
Azerbaijan	42.6	104.4	70.1	63.4	74.1	-56.0	39.2
Georgia	31.5	34.8	13.2	25.3	19.7	-3.2	8.4
Kazakhstan	55.7	37.4	37.0	24.7	49.0	-36.9	13.2
Kyrgyz Republic	24.2	-6.3	31.9	47.6	39.0	19.5	19.5
Tajikistan	20.9	-68.2	1.2	10.0	10.1	2.1	4.4
Turkmenistan	11.2	28.3	44.7	27.4	30.6	-	-
Uzbekistan	31.6	11.6	18.0	42.9	25.0	9.7	10.9
East Asia	28.0	19.0	19.7	18.9	13.4	-6.2	8.6
China, People's Rep. of	35.4	28.5	27.2	25.8	17.3	-4.3	8.0
Hong Kong, China	15.9	11.2	9.7	8.9	5.6	-5.0	8.0
Korea, Rep. of	30.6	12.1	14.8	14.2	14.3	-15.0	10.0
Mongolia	39.0	22.2	44.8	26.3	29.7	-	-
Taipei,China	21.1	8.8	12.8	10.1	3.4	-3.5	10.8
South Asia	24.0	21.0	20.7	24.5	12.4	-7.9	8.5
Afghanistan, Islamic Rep. of	-13.2	9.2	0.9	1.3	17.5	-6.1	11.2
Bangladesh	15.9	14.0	21.5	15.8	15.7	14.0	13.0
Bhutan	39.7	34.5	47.2	64.5	-8.5	-12.2	6.7
India	28.5	23.4	22.6	28.9	11.9	-9.1	8.9
Maldives	19.1	-10.7	39.4	1.2	52.6	-	-
Nepal	14.8	11.4	2.6	1.9	12.8	-	-
Pakistan	13.8	16.2	14.9	4.4	16.5	-6.0	2.0
Sri Lanka	12.2	10.2	8.5	11.0	6.5	-22.0	4.6
Southeast Asia	20.0	15.7	17.1	12.2	14.5	-17.7	7.6
Brunei Darussalam	14.6	23.3	22.1	2.3	28.5	-14.5	3.3
Cambodia	24.1	12.4	26.9	10.7	-	-	-
Indonesia	10.4	22.9	19.0	14.0	18.0	-25.0	14.6
Lao People's Dem. Rep.	8.3	88.3	67.1	5.2	21.2	-20.0	-
Malaysia	21.1	12.3	12.9	9.6	12.8	-13.3	5.8
Myanmar	4.4	21.7	47.4	22.3	-	-	-
Philippines	9.8	3.8	15.6	6.4	-2.6	-8.4	14.6
Singapore	23.3	16.8	18.1	10.5	13.1	-16.0	5.0
Thailand	21.6	15.2	17.0	17.3	16.8	-18.0	8.0
Viet Nam	31.4	22.5	22.7	21.9	29.1	-31.8	8.1
The Pacific	12.0	21.6	21.0	11.4	22.3	-	-
Cook Islands	7.8	14.8	8.1	35.7	-	-	-
Fiji Islands	-5.8	6.3	2.5	5.9	23.1	-	-
Kiribati	-26.4	63.6	-55.1	-	-	-	-
Marshall Islands, Rep. of	28.7	28.6	-10.1	2.5	-	-	-
Micronesia, Fed. States of	-39.9	8.8	-8.1	15.9	18.3	3.9	-
Nauru	-	-81.6	85.6	618.6	-	-	-
Palau, Rep. of	-30.1	128.1	1.3	-25.8	-	-	-
Papua New Guinea	18.1	26.5	26.8	11.5	22.9	-	-
Samoa	-19.2	0.6	-13.7	33.7	-28.7	-	-
Solomon Islands	31.0	6.4	16.4	39.6	2.8	-	-
Timor-Leste, Dem. Rep. of	0.0	12.5	2.8	-28.2	75.2	-	-
Tonga	-21.1	15.9	-4.0	-13.9	-7.0	-	-
Tuvalu	-	-	-	-	-	-	-
Vanuatu	43.3	0.1	-1.1	-42.4	46.8	-	-
Average	25.6	18.5	19.5	17.8	14.6	-10.2	8.6

- = not available.

Table A11 Direction of exports (% of total)

From \ To	Developing Asia		China, People's Rep. of		Japan		United States		European Union		Others	
	2000	2007	2000	2007	2000	2007	2000	2007	2000	2007	2000	2007
Central Asia	9.2	10.0	4.1	10.1	0.5	0.7	1.7	2.2	28.1	32.5	56.4	44.5
Armenia	7.8	9.4	0.2	0.7	0.1	0.0	12.6	5.7	36.9	41.0	42.5	43.2
Azerbaijan	7.1	22.9	0.3	0.2	0.0	0.0	0.5	1.6	63.6	57.9	28.6	17.4
Georgia	16.2	19.3	0.3	0.9	0.1	0.0	2.2	3.8	24.0	12.3	57.2	63.7
Kazakhstan	5.4	5.2	6.8	15.5	0.1	0.8	2.1	2.4	23.0	36.3	62.6	39.8
Kyrgyz Republic	29.0	40.0	8.8	5.4	0.1	0.1	0.6	0.8	37.6	2.8	23.9	50.9
Tajikistan	16.5	9.2	0.4	0.6	-	0.0	0.1	0.0	30.1	43.2	52.9	47.0
Turkmenistan	6.4	8.1	0.3	0.6	-	0.0	0.5	1.0	21.5	8.6	71.3	81.7
Uzbekistan	23.6	21.0	0.5	5.6	3.2	2.7	1.5	2.3	26.8	18.6	44.3	49.8
East Asia	25.9	27.3	11.7	14.1	11.4	7.2	21.8	14.4	15.2	13.5	13.9	23.4
China, People's Rep. of	32.9	33.1	-	-	16.3	7.4	20.4	16.4	16.1	14.6	14.3	28.6
Hong Kong, China	10.2	10.2	34.1	48.4	5.5	4.5	23.0	13.8	15.5	12.8	11.8	10.3
Korea, Rep. of	23.8	21.4	10.2	21.2	11.3	6.9	20.9	11.2	13.7	12.6	20.2	26.8
Mongolia	4.0	1.8	49.8	71.9	1.5	0.5	24.3	6.3	7.7	3.1	12.6	16.4
Taipei,China	38.2	31.9	2.9	25.3	11.2	10.8	23.6	10.8	15.2	10.8	8.8	10.5
South Asia	17.3	20.1	1.6	7.3	3.6	2.1	24.2	15.0	26.3	19.0	26.9	36.5
Afghanistan, Islamic Rep. of	46.0	55.6	3.4	0.6	0.3	0.2	1.9	12.2	35.3	14.0	13.1	17.4
Bangladesh	5.4	5.4	0.2	0.7	1.2	0.8	31.7	22.5	40.1	42.7	21.5	27.9
Bhutan	-	-	-	-	-	-	-	-	-	-	-	-
India	19.2	21.2	1.8	8.6	4.1	2.4	21.1	13.4	24.1	16.5	29.8	37.9
Maldives	32.0	41.5	-	0.2	4.1	10.6	44.0	1.3	18.5	31.0	1.4	15.5
Nepal	44.5	71.7	-	1.3	1.4	0.8	27.4	9.6	23.0	10.0	3.7	6.7
Pakistan	18.5	20.6	2.6	5.1	2.6	1.0	24.9	18.5	27.7	19.5	23.6	35.4
Sri Lanka	8.6	12.7	0.1	0.4	4.2	2.1	40.1	25.9	28.2	29.9	18.9	29.0
Southeast Asia	37.4	41.2	3.7	8.9	12.6	9.4	18.2	12.2	14.4	11.1	13.7	17.2
Brunei Darussalam	36.2	41.3	1.8	3.2	40.7	29.8	12.0	7.5	3.6	1.9	5.8	16.4
Cambodia	8.2	8.9	2.1	1.1	0.9	0.8	65.4	46.6	20.5	15.9	2.9	26.6
Indonesia	33.1	37.1	4.2	8.1	22.1	18.1	13.0	9.4	13.7	10.0	13.7	17.3
Lao People's Dem. Rep.	43.4	55.5	1.5	5.7	2.8	0.8	2.2	0.6	26.0	8.8	24.1	28.5
Malaysia	40.3	40.9	2.9	8.5	12.3	7.8	19.5	16.6	13.3	11.2	11.7	15.0
Myanmar	35.2	70.0	5.6	7.0	5.4	4.7	22.0	0.0	16.4	6.7	15.5	11.6
Philippines	30.5	34.6	1.6	10.9	13.4	14.7	27.3	16.3	16.5	16.5	10.7	7.0
Singapore	44.1	51.2	3.8	9.5	7.3	4.9	16.7	9.1	13.5	10.1	14.7	15.2
Thailand	30.8	33.5	3.9	9.5	14.2	10.6	20.5	12.6	15.7	11.5	15.0	22.3
Viet Nam	25.8	21.9	10.3	6.8	17.2	10.6	4.9	15.8	20.0	14.2	21.9	30.7
The Pacific	11.2	10.5	5.2	6.4	10.3	6.7	5.3	2.8	11.1	6.7	56.9	67.0
Cook Islands	-	-	-	-	-	-	-	-	-	-	-	-
Fiji Islands	14.3	11.8	0.0	0.2	4.1	4.9	21.1	15.6	16.5	13.2	44.0	54.3
Kiribati	-	-	-	-	-	-	-	-	-	-	-	-
Marshall Islands, Rep of	-	-	-	-	-	-	-	-	-	-	-	-
Micronesia, Fed. States of	-	-	-	-	-	-	-	-	-	-	-	-
Nauru	-	-	-	-	-	-	-	-	-	-	-	-
Palau, Rep. of	-	-	-	-	-	-	-	-	-	-	-	-
Papua New Guinea	7.6	7.1	6.5	5.7	11.2	6.9	1.3	1.1	10.2	6.2	63.2	73.0
Samoa	18.1	9.2	0.1	0.2	0.3	0.5	10.6	2.5	3.0	0.5	67.9	87.1
Solomon Islands	42.3	25.0	12.0	50.8	20.7	6.5	0.7	0.8	10.6	4.1	13.6	12.9
Timor-Leste, Dem. Rep. of	-	-	-	-	-	-	-	-	-	-	-	-
Tonga	6.3	17.9	-	0.2	48.5	32.2	30.0	46.0	6.5	1.5	8.7	2.2
Tuvalu	-	-	-	-	-	-	-	-	-	-	-	-
Vanuatu	60.7	81.0	0.4	0.1	18.7	10.2	9.7	0.8	5.7	3.0	4.8	4.9
Developing Asia	29.2	30.2	8.4	12.2	11.3	7.3	20.3	13.6	15.6	13.6	15.1	23.1

- = not available.

Table A12 Growth rate of merchandise imports (% per year)

	2004	2005	2006	2007	2008	2009	2010
Central Asia	34.1	20.7	27.4	37.7	21.4	-7.0	5.3
Armenia	5.8	33.1	20.6	45.6	35.0	21.5	-4.8
Azerbaijan	31.5	21.4	21.1	14.7	19.4	-1.4	8.0
Georgia	36.7	33.8	37.2	35.2	20.0	-3.1	13.4
Kazakhstan	44.6	30.1	34.2	37.9	15.8	-19.3	1.2
Kyrgyz Republic	25.0	22.3	62.1	47.0	38.4	19.2	19.2
Tajikistan	23.5	-21.9	38.0	54.0	43.8	3.1	5.9
Turkmenistan	22.1	-6.4	-13.2	47.8	50.8	-	-
Uzbekistan	27.3	8.1	16.0	49.2	15.0	19.9	11.4
East Asia	28.7	14.4	16.6	15.8	16.1	-9.6	10.2
China, People's Rep. of	35.8	17.6	19.7	20.3	19.4	-7.4	10.0
Hong Kong, China	17.0	10.2	11.6	10.3	6.2	-6.5	8.2
Korea, Rep. of	25.6	16.4	18.6	15.4	21.8	-20.0	12.0
Mongolia	17.4	20.0	20.8	42.3	56.3	-	-
Taipei,China	32.6	8.5	11.5	8.2	9.6	-6.3	11.6
South Asia	39.5	30.2	21.3	29.6	17.7	-9.5	9.8
Afghanistan, Islamic Rep. of	16.1	20.5	10.0	16.2	12.3	-1.2	0.3
Bangladesh	13.0	20.6	12.1	16.6	25.6	18.0	17.0
Bhutan	27.3	75.5	-5.6	15.1	9.1	-17.9	-5.0
India	48.6	32.1	21.4	35.2	15.6	-10.9	11.5
Maldives	36.3	16.1	24.4	18.3	32.3	-	-
Nepal	15.9	12.5	17.8	13.1	26.3	-	-
Pakistan	20.0	37.8	33.3	8.0	31.2	-14.5	-5.0
Sri Lanka	19.9	10.8	15.7	10.2	24.0	-10.8	4.0
Southeast Asia	24.7	18.4	13.6	13.0	20.5	-18.2	8.3
Brunei Darussalam	6.3	5.6	12.2	24.5	12.3	1.5	2.8
Cambodia	22.5	19.4	21.1	14.6	-	-	-
Indonesia	28.0	37.2	6.3	15.4	36.0	-22.9	10.9
Lao People's Dem. Rep.	54.2	30.9	18.3	91.5	11.9	-15.0	8.0
Malaysia	25.6	9.2	14.5	12.1	6.3	-10.1	5.9
Myanmar	-11.9	0.6	48.0	14.2	-	-	-
Philippines	8.0	8.0	10.9	8.7	5.0	-12.2	10.8
Singapore	27.4	16.4	18.2	10.6	21.9	-14.0	6.0
Thailand	25.7	25.8	7.9	9.1	26.4	-28.0	14.0
Viet Nam	26.6	21.2	22.1	38.3	28.1	-27.0	5.3
The Pacific	17.0	9.9	18.7	20.1	19.7	-	-
Cook Islands	12.1	7.9	11.7	45.3	-	-	-
Fiji Islands	18.3	13.1	12.8	9.7	26.2	-	-
Kiribati	1.5	23.3	-15.5	-	-	-	-
Marshall Islands, Rep. of	-4.1	12.0	-3.0	3.4	-	-	-
Micronesia, Fed. States of	14.3	2.5	3.7	0.9	12.8	-6.7	-
Nauru	-	-8.2	17.1	11.1	-	-	-
Palau, Rep. of	21.6	-2.0	9.6	-20.8	-	-	-
Papua New Guinea	22.0	4.4	30.5	32.1	13.7	-	-
Samoa	22.7	20.6	16.7	3.7	17.9	-	-
Solomon Islands	3.1	67.5	54.3	22.8	-	-	-
Timor-Leste, Dem. Rep. of	-0.8	-3.1	-19.5	74.6	35.7	-	-
Tonga	11.5	27.5	15.8	-11.4	27.4	-	-
Tuvalu	-	-	-	-	-	-	-
Vanuatu	23.5	6.0	24.1	20.2	31.0	-	-
Average	28.5	16.9	16.5	16.8	17.5	-11.8	9.6

- = not available.

Table A13 Trade balance (US$ million)

	2004	2005	2006	2007	2008	2009	2010
Central Asia	7,159	14,222	23,971	30,477	62,483	15,035	25,897
Armenia	-458	-588	-896	-1,600	-2,665	-3,500	-3,236
Azerbaijan	161	3,299	7,745	15,224	29,821	9,185	14,999
Georgia	-916	-1,214	-2,019	-2,896	-3,500	-3,392	-3,969
Kazakhstan	6,785	10,322	14,642	15,091	33,512	14,387	20,010
Kyrgyz Republic	-171	-419	-886	-1,299	-1,789	-2,127	-2,529
Tajikistan	-151	-622	-986	-1,673	-2,535	-2,618	-2,779
Turkmenistan	705	1,997	4,598	5,334	6,200	-	-
Uzbekistan	1,202	1,447	1,774	2,296	3,440	3,100	3,400
East Asia	104,505	178,597	255,955	354,243	351,442	404,317	409,014
China, People's Rep. of	58,983	134,189	217,746	315,381	351,000	370,000	380,000
Hong Kong, China	-9,311	-7,631	-14,029	-19,699	-23,128	-16,146	-18,164
Korea, Rep. of	37,569	32,683	27,905	28,168	5,994	26,466	22,274
Mongolia	-99	-100	136	-52	-600	-	-
Taipei,China	17,363	19,456	24,197	30,445	18,176	23,996	24,904
South Asia	-44,456	-68,340	-83,659	-117,004	-148,784	-127,824	-143,230
Afghanistan, Islamic Rep. of	-3,443	-4,335	-4,933	-6,002	-6,647	-6,677	-6,475
Bangladesh	-2,319	-3,297	-2,889	-3,458	-5,541	-7,096	-8,938
Bhutan	-105	-249	-123	13	-77	-36	14
India	-33,702	-51,904	-61,782	-91,626	-112,000	-96,500	-112,000
Maldives	-384	-494	-590	-737	-928	-	-
Nepal	-1,052	-1,193	-1,531	-1,828	-2,426	-	-
Pakistan	-1,208	-4,352	-8,441	-9,711	-15,295	-11,367	-9,474
Sri Lanka	-2,243	-2,517	-3,370	-3,655	-5,871	-6,148	-6,356
Southeast Asia	75,512	74,624	107,904	116,464	86,747	75,650	76,730
Brunei Darussalam	3,728	4,834	6,041	5,828	7,809	6,322	6,542
Cambodia	-680	-994	-1,033	-1,330	-	-	-
Indonesia	20,152	17,533	29,660	32,754	23,310	15,083	20,580
Lao People's Dem. Rep.	-349	-249	39	-911	-908	-845	-1,006
Malaysia	27,572	34,034	36,682	37,140	50,937	39,430	41,584
Myanmar	929	1,547	2,266	3,010	-	-	-
Philippines	-5,684	-7,773	-6,732	-8,391	-12,582	-9,221	-8,540
Singapore	30,670	36,384	42,762	47,152	30,726	19,558	17,848
Thailand	1,460	-8,254	994	11,572	237	17,701	11,555
Viet Nam	-2,287	-2,439	-2,776	-10,360	-12,782	-12,379	-11,833
The Pacific	-198	207	350	61	482	-	-
Cook Islands	12	21	19	13	10	12	11
Fiji Islands	-634	-762	-931	-1,049	-1,346	-	-
Kiribati	-79	-95	-83	-	-	-	-
Marshall Islands, Rep. of	-53	-56	-56	-58	-	-	-
Micronesia, Fed. States of	-120	-122	-129	-128	-143	-131	-138
Nauru	-19	21	25	35	-	-	-
Palau, Rep. of	-101	-92	-102	-81	-	-	-
Papua New Guinea	1,161	1,793	2,216	2,058	2,773	-	-
Samoa	-143	-175	-208	-213	-258	-	-
Solomon Islands	25	-17	-66	-61	-	-	-
Timor-Leste, Dem. Rep. of	-121	-116	-91	-169	-227	-	-
Tonga	-69	-90	-107	-95	-126	-	-
Tuvalu	-	-	-	-	-	-	-
Vanuatu	-75	-81	-111	-157	-202	-	-
Total	142,522	199,311	304,522	384,242	352,370	367,059	368,284

- = not available.

Table A14 Current account balance (US$ million)

	2004	2005	2006	2007	2008	2009	2010
Central Asia	-1,384	1,074	6,336	6,751	36,435	17,327	15,139
Armenia	-20	-52	-117	-589	-1,372	-927	-1,025
Azerbaijan	-2,589	167	3,708	9,019	22,016	13,889	9,940
Georgia	-353	-710	-1,174	-2,006	-2,575	-2,429	-2,934
Kazakhstan	335	-1,056	-1,999	-7,333	8,914	-2,033	-598
Kyrgyz Republic	28	-38	-287	-228	-531	-557	-655
Tajikistan	-83	-62	-79	-414	-466	-538	-483
Turkmenistan	82	875	3,351	4,037	5,800	6,677	7,345
Uzbekistan	1,215	1,949	2,933	4,267	4,650	3,244	3,548
East Asia	132,355	213,644	308,260	436,385	488,563	482,305	502,959
China, People's Rep. of	68,660	160,818	253,268	371,833	440,000	418,000	434,700
Hong Kong, China	15,730	20,180	22,935	25,530	30,622	19,271	22,482
Korea, Rep. of	28,174	14,981	5,385	5,876	-6,406	13,400	11,700
Mongolia	63	88	372	172	-677	-379	-340
Taipei,China	19,728	17,578	26,300	32,975	25,024	32,014	34,416
South Asia	-1,938	-13,391	-16,063	-25,035	-51,675	-28,175	-35,970
Afghanistan, Islamic Rep. of	-265	-182	-379	85	-159	-502	-746
Bangladesh	176	-557	824	936	672	177	-487
Bhutan	-122	-235	-38	114	52	67	124
India	-2,470	-9,902	-9,766	-17,403	-35,000	-18,000	-27,000
Maldives	-122	-273	-302	-412	-637	-	-
Nepal	198	161	198	-13	333	-	-
Pakistan	1,314	-1,753	-5,101	-6,878	-14,036	-9,918	-7,862
Sri Lanka	-647	-649	-1,499	-1,464	-2,900	-	-
Southeast Asia	41,886	45,624	84,521	98,430	67,712	56,935	67,876
Brunei Darussalam	2,896	4,038	5,232	4,980	6,882	5,435	5,622
Cambodia	-435	-606	-521	-670	-1,186	-1,454	-962
Indonesia	1,564	278	10,859	10,492	606	-1,887	2,806
Lao People's Dem. Rep.	-189	-536	-453	-769	-933	-825	-837
Malaysia	15,079	20,693	25,490	29,209	39,740	29,018	31,909
Myanmar	251	444	1,032	1,803	-	-	-
Philippines	1,628	1,984	5,347	7,119	4,227	1,618	3,280
Singapore	19,888	27,468	35,383	39,209	26,984	15,759	23,888
Thailand	2,767	-7,642	2,315	14,049	-178	19,935	11,680
Viet Nam	-1,564	-497	-164	-6,992	-8,430	-10,663	-9,509
The Pacific	-1,809	325	-16	492	-432	-1,605	-1,674
Cook Islands	12	21	19	13	10	12	11
Fiji Islands	-1,875	-395	-717	-587	-792	-836	-890
Kiribati	-26	-60	-43	-58	-59	-	-
Marshall Islands, Rep. of	-39	-43	-41	-43	-43	-	-
Micronesia, Fed. States of	-45	-29	-39	-30	-50	-36	-49
Nauru	-42	-7	-5	-2	-	-	-
Palau, Rep. of	-10	-6	-24	8	-	-	-
Papua New Guinea	122	608	410	126	694	-581	-560
Samoa	-27	-20	-45	-23	-59	-	-
Solomon Islands	67	2	-22	-17	-35	-81	-100
Timor-Leste, Dem. Rep. of	26	275	540	1,177	-	-	-
Tonga	8	-6	-23	-25	-31	-	-
Tuvalu	-	-	-	-	-	-	-
Vanuatu	-22	-22	-31	-49	-67	-84	-86
Total	169,109	247,276	383,038	517,024	540,602	526,787	548,329

- = not available.

Table A15 Current account balance (% of GDP)

	2004	2005	2006	2007	2008	2009	2010
Central Asia	-1.7	0.9	3.2	1.7	12.2	3.8	3.4
Armenia	-0.5	-1.1	-1.8	-6.4	-11.5	-9.0	-9.5
Azerbaijan	-29.8	1.3	17.7	27.3	47.7	25.5	17.7
Georgia	-6.9	-11.1	-15.2	-19.7	-20.1	-18.8	-20.0
Kazakhstan	0.8	-1.8	-2.5	-7.0	6.7	-2.0	-0.5
Kyrgyz Republic	1.3	-1.6	-10.1	-6.0	-10.5	-10.0	-10.0
Tajikistan	-4.0	-2.7	-2.8	-11.2	-9.3	-8.8	-7.0
Turkmenistan	0.6	5.1	16.3	16.1	33.4	35.0	35.0
Uzbekistan	10.2	14.3	17.2	19.1	18.0	11.0	10.5
East Asia	4.3	6.0	7.6	8.7	7.7	7.1	6.7
China, People's Rep. of	3.6	7.2	9.5	11.0	10.1	8.4	7.8
Hong Kong, China	9.5	11.4	12.1	12.3	14.2	9.0	10.0
Korea, Rep. of	4.1	1.9	0.6	0.6	-0.7	1.9	1.4
Mongolia	3.5	3.8	11.8	4.4	-12.9	-7.0	-6.0
Taipei,China	6.0	4.9	7.2	8.6	6.4	8.4	8.3
South Asia	-0.2	-1.3	-1.4	-1.7	-3.4	-2.0	-2.3
Afghanistan, Islamic Rep. of	-4.5	-2.8	-4.9	0.9	-1.3	-3.5	-4.7
Bangladesh	0.3	-0.9	1.3	1.4	0.9	0.2	-0.5
Bhutan	-17.9	-30.5	-4.4	11.0	3.9	5.5	9.0
India	-0.4	-1.2	-1.1	-1.5	-3.0	-1.5	-2.0
Maldives	-15.7	-36.4	-33.0	-39.1	-50.6	-30.0	-30.0
Nepal	2.7	2.0	2.2	-0.1	2.6	1.5	1.0
Pakistan	1.3	-1.6	-4.0	-4.8	-8.4	-6.0	-4.5
Sri Lanka	-3.1	-2.7	-5.3	-4.5	-7.1	-7.5	-7.0
Southeast Asia	5.1	4.9	7.9	7.6	4.7	4.4	4.9
Brunei Darussalam	36.8	42.4	45.6	40.5	46.1	39.3	35.3
Cambodia	-8.2	-9.6	-7.2	-7.8	-14.0	-16.0	-10.0
Indonesia	0.6	0.1	2.9	2.4	0.1	-0.6	0.8
Lao People's Dem. Rep.	-8.0	-17.8	-13.7	-19.7	-18.9	-15.9	-16.0
Malaysia	12.1	15.0	16.3	15.6	17.9	14.0	13.8
Myanmar	2.4	3.7	7.1	9.1	-	-	-
Philippines	1.9	2.0	4.5	4.9	2.5	1.0	2.0
Singapore	18.1	22.7	25.4	23.5	14.8	10.0	14.0
Thailand	1.7	-4.3	1.1	5.7	-0.1	8.0	4.5
Viet Nam	-3.4	-0.9	-0.3	-9.9	-9.3	-11.5	-9.7
The Pacific	-20.4	5.5	10.1	38.7	-4.8	-13.2	-12.8
Cook Islands	7.0	11.5	10.4	6.2	4.5	5.0	4.1
Fiji Islands	-68.7	-13.2	-22.6	-17.3	-21.0	-25.0	-25.0
Kiribati	-40.3	-98.5	-69.8	-75.4	-71.3	-	-
Marshall Islands, Rep. of	-29.3	-30.7	-28.3	-27.7	-26.0	-	-
Micronesia, Fed. States of	-20.0	-12.5	-16.3	-12.8	-20.4	-14.2	-19.0
Nauru	-147.7	-25.5	-18.4	-10.3	-	-	-
Palau, Rep. of	-7.3	-4.0	-15.1	4.6	-	-	-
Papua New Guinea	3.1	12.4	7.3	2.0	8.7	-7.0	-6.0
Samoa	-7.1	-4.7	-9.9	-4.3	-10.2	-	-
Solomon Islands	17.9	0.5	-4.1	-2.6	-4.9	-10.1	-12.1
Timor-Leste, Dem. Rep. of	9.3	87.6	179.2	348.3	-	-	-
Tonga	4.0	-2.7	-9.6	-10.1	-10.8	-	-
Tuvalu	-	-	-	-	-	-	-
Vanuatu	-6.8	-6.1	-7.5	-9.9	-11.4	-13.2	-13.0
Average	3.5	4.4	5.9	6.5	5.3	4.9	4.7

- = not available.

Table A16 Foreign direct investment (US$ million)

	2004	2005	2006	2007	2008
Central Asia					
Armenia	246	233	450	701	815
Azerbaijan	3,556	1,680	-584	-4,850	-395
Georgia	483	542	1,186	1,676	1,260
Kazakhstan	4,157	1,971	6,278	10,189	7,843
Kyrgyz Republic	132	43	182	208	193
Tajikistan	272	54	339	360	-
Turkmenistan	354	418	731	856	1,200
Uzbekistan	187	88	195	739	1,000
East Asia					
China, People's Rep. of	60,630	72,406	72,715	83,521	92,395
Hong Kong, China	34,035	33,627	45,058	54,343	-
Korea, Rep. of	9,246	6,309	3,586	1,784	2,200
Mongolia	93	185	191	360	683
Taipei,China	1,898	1,625	7,424	7,769	5,432
South Asia					
Afghanistan, Islamic Rep. of	187	271	238	243	300
Bangladesh	385	800	743	793	650
Bhutan	3	9	6	73	30
India	5,987	8,901	21,991	32,327	20,700
Maldives	15	10	14	15	16
Nepal	0	2	-6	5	5
Pakistan	906	1,459	3,450	5,026	5,078
Sri Lanka	217	234	451	548	313
Southeast Asia					
Brunei Darussalam	111	167	433	475	550
Cambodia	121	375	475	820	-
Indonesia	1,896	8,336	4,914	6,928	8,340
Lao People's Dem. Rep.	450	500	650	770	-
Malaysia	4,624	4,065	6,047	8,460	-
Myanmar	-	-	-	-	-
Philippines	688	1,854	2,921	2,916	1,520
Singapore	20,053	14,373	27,680	31,550	22,726
Thailand	5,786	7,545	8,487	9,381	7,703
Viet Nam	1,610	1,889	2,315	6,550	8,000
The Pacific					
Cook Islands	-	-	-	-	-
Fiji Islands	-	-	-	-	-
Kiribati	-	-	-	-	-
Marshall Islands, Rep. of	4	6	6	-	-
Micronesia, Fed. States of	-	-	-	-	-
Nauru	-	-	-	-	-
Palau, Rep. of	-	-	-	-	-
Papua New Guinea	-	-	-	-	-
Samoa	-	-	-	-	-
Solomon Islands	-	-	-	-	-
Timor-Leste, Dem. Rep. of	-	-	-	-	-
Tonga	-	-	-	-	-
Tuvalu	-	-	-	-	-
Vanuatu	-	-	-	-	-

- = not available.

Table A17 External debt outstanding (US$ million)

	2004	2005	2006	2007	2008
Central Asia					
Armenia	1,183	1,099	1,206	1,449	1,650
Azerbaijan	1,740	1,651	1,765	2,442	3,001
Georgia	1,858	1,735	1,697	1,790	2,676
Kazakhstan	32,713	43,249	74,014	96,716	102,727
Kyrgyz Republic	2,107	2,003	2,213	2,280	2,357
Tajikistan	824	897	910	1,232	1,556
Turkmenistan	1,247	907	712	627	-
Uzbekistan	4,322	4,133	3,853	3,913	3,980
East Asia					
China, People's Rep. of	247,679	283,803	325,077	373,635	420,000
Hong Kong, China	429,336	453,201	516,832	711,133	656,912
Korea, Rep. of	172,259	187,882	260,061	383,152	380,495
Mongolia	1,360	1,312	1,414	1,529	-
Taipei,China	80,888	86,732	85,833	94,525	-
South Asia					
Afghanistan, Islamic Rep. of	761	11,940	11,971	2,009	2,263
Bangladesh	17,953	18,416	18,603	19,355	20,110
Bhutan	529	596	689	725	780
India	132,973	138,133	169,669	221,212	-
Maldives	332	397	574	840	975
Nepal	3,069	3,122	3,249	3,341	3,269
Pakistan	33,368	34,037	35,889	39,008	44,467
Sri Lanka	11,346	11,354	12,214	14,252	15,077
Southeast Asia					
Brunei Darussalam	-	-	-	-	-
Cambodia	2,038	2,120	2,254	2,582	2,800
Indonesia	137,024	130,652	128,736	136,640	129,070
Lao People's Dem. Rep.	1,961	2,209	2,471	2,853	-
Malaysia	52,786	52,301	52,245	56,681	70,479
Myanmar	6,630	6,863	7,303	7,404	-
Philippines	54,846	54,186	53,367	54,938	53,482
Singapore	214,833	233,435	273,807	326,084	427,715
Thailand	51,312	52,040	59,643	61,738	64,805
Viet Nam	15,266	16,833	18,330	23,673	27,240
The Pacific					
Cook Islands	-	-	-	-	-
Fiji Islands	281	285	445	461	576
Kiribati	40	47	47	52	-
Marshall Islands, Rep. of	94	93	100	99	100
Micronesia, Fed. States of	64	65	68	67	68
Nauru	-	-	-	310	-
Palau, Rep. of	20	19	18	23	-
Papua New Guinea	1,371	1,243	1,184	1,037	1,061
Samoa	170	167	167	187	179
Solomon Islands	153	143	151	147	-
Timor-Leste, Dem. Rep. of	-	-	-	-	-
Tonga	77	81	82	82	83
Tuvalu	-	-	-	-	-
Vanuatu	121	82	86	-	-

- = not available.

Table A18 Debt service ratio (% of exports of goods and services)

	2004	2005	2006	2007	2008
Central Asia					
Armenia	8.9	4.4	3.9	2.9	-
Azerbaijan	4.0	2.2	1.5	0.4	-
Georgia	5.4	4.4	7.8	4.5	3.3
Kazakhstan	36.2	36.2	28.5	48.6	43.6
Kyrgyz Republic	29.1	23.4	11.0	14.7	3.0
Tajikistan	3.2	10.0	7.5	6.4	12.6
Turkmenistan	9.6	5.6	4.6	-	-
Uzbekistan	17.1	14.1	12.7	8.6	7.5
East Asia					
China, People's Rep. of	3.5	3.3	2.6	2.4	2.2
Hong Kong, China	-	-	-	-	-
Korea, Rep. of	4.4	3.2	4.4	5.4	5.3
Mongolia	3.2	2.8	1.8	2.4	-
Taipei,China	2.9	5.4	3.2	1.7	-
South Asia					
Afghanistan, Islamic Rep. of	3.9	5.7	1.6	1.1	1.3
Bangladesh	5.0	4.8	4.1	3.7	3.2
Bhutan	6.8	11.9	7.6	3.6	17.9
India	6.0	9.9	4.8	5.4	-
Maldives	4.1	6.5	4.1	4.5	5.0
Nepal	8.8	9.4	9.3	11.7	9.9
Pakistan	32.5	14.9	13.8	12.9	12.3
Sri Lanka	11.6	7.9	12.7	13.0	14.3
Southeast Asia					
Brunei Darussalam	-	-	-	-	-
Cambodia	1.5	1.3	1.1	0.5	0.8
Indonesia	30.1	17.3	24.8	19.0	18.0
Lao People's Dem. Rep.	8.9	7.4	4.5	4.3	-
Malaysia	4.5	5.4	4.8	3.8	3.1
Myanmar	3.9	2.8	-	-	-
Philippines	13.8	13.5	10.7	9.8	9.8
Singapore	-	-	-	-	-
Thailand	8.5	10.8	11.3	11.8	6.7
Viet Nam	6.1	5.3	5.3	5.5	6.5
The Pacific					
Cook Islands	-	-	-	-	-
Fiji Islands	1.5	1.3	1.8	1.9	2.7
Kiribati	3.1	3.3	3.6	-	-
Marshall Islands, Rep. of	20.8	20.9	20.0	37.0	17.3
Micronesia, Fed. States of	7.3	6.8	9.1	6.5	-
Nauru	-	-	-	-	-
Palau, Rep. of	1.1	1.5	1.1	1.0	-
Papua New Guinea	1.3	0.7	1.3	2.3	-
Samoa	5.7	4.0	3.3	3.3	3.5
Solomon Islands	5.9	7.2	4.3	4.3	-
Timor-Leste, Dem. Rep. of	-	-	-	-	-
Tonga	8.1	8.5	9.1	10.5	-
Tuvalu	-	-	-	-	-
Vanuatu	1.5	1.0	1.7	1.4	-

- = not available.

Table A19 Exchange rates to the US dollar (annual average)

	Currency	Symbol	2004	2005	2006	2007	2008
Central Asia							
Armenia	Dram	AMD	533.5	457.7	416.0	342.1	306.0
Azerbaijan	Azerbaijan new manat	AZN	1.0	0.9	0.9	0.9	0.8
Georgia	Georgian lari	GEL	1.9	1.8	1.8	1.7	1.5
Kazakhstan	Tenge	T	136.0	132.9	126.1	122.6	120.3
Kyrgyz Republic	Som	Som	42.7	41.0	40.2	37.3	36.6
Tajikistan	Somoni	TJS	3.0	3.1	3.3	3.4	3.4
Turkmenistan	Turkmen manat	TMM	5,200.0	5,200.0	5,200.0	5,200.0	14,250.0
Uzbekistan	Sum	SUM	1,020.0	1,115.0	1,220.0	1,263.7	1,375.5
East Asia							
China, People's Rep. of	Yuan	CNY	8.3	8.2	8.0	7.6	6.9
Hong Kong, China	Hong Kong dollar	HK$	7.8	7.8	7.8	7.8	7.8
Korea, Rep. of	Won	W	1,146.2	1,024.2	955.3	929.4	1,100.1
Mongolia	Togrog	MNT	1,185.3	1,205.3	1,177.4	1,170.4	1,166.1
Taipei,China	NT dollar	NT$	33.4	32.2	32.5	32.8	31.5
South Asia							
Afghanistan, Islamic Rep. of	Afghani	AF	47.8	49.7	49.9	49.8	50.2
Bangladesh	Taka	Tk	58.9	61.4	67.1	69.0	68.6
Bhutan	Ngultrum	Nu	45.4	44.6	44.7	44.2	40.3
India	Indian rupee/s	Re/Rs	44.9	44.3	45.3	40.3	46.0
Maldives	Rufiyaa	Rf	12.8	12.8	12.8	12.8	12.8
Nepal	Nepalese rupee/s	NRe/NRs	73.8	71.9	71.9	70.5	65.0
Pakistan	Pakistan rupee/s	PRe/PRs	57.6	59.4	59.9	60.6	62.5
Sri Lanka	Sri Lanka rupee/s	SLRe/SLRs	101.2	100.5	104.0	110.6	108.3
Southeast Asia							
Brunei Darussalam	Brunei dollar	B$	1.7	1.7	1.6	1.5	1.4
Cambodia	Riel	KR	4,019.0	4,097.0	4,107.0	4,060.0	4,054.9
Indonesia	Rupiah	Rp	8,934.6	9,712.0	9,020.0	9,136.2	9,678.3
Lao People's Dem. Rep.	Kip	KN	10,585.5	10,655.2	10,159.9	9,680.0	8,740.0
Malaysia	Ringgit	RM	3.8	3.8	3.7	3.4	3.3
Myanmar	Kyat	MK	5.8	5.8	5.8	5.6	5.8
Philippines	Peso	P	56.1	55.0	51.2	45.9	44.4
Singapore	Singapore dollar	S$	1.7	1.7	1.6	1.5	1.4
Thailand	Baht	B	40.2	40.2	37.9	34.5	33.4
Viet Nam	Dong	D	15,746.0	15,858.9	15,994.3	16,126.0	16,303.7
The Pacific							
Cook Islands	New Zealand dollar	NZ$	1.5	1.4	1.5	1.4	1.4
Fiji Islands	Fiji dollar	F$	1.7	1.7	1.7	1.6	1.6
Kiribati	Australian dollar	A$	1.4	1.3	1.3	1.2	1.2
Marshall Islands, Rep. of	US dollar	US$	1.0	1.0	1.0	1.0	1.0
Micronesia, Fed. States of	US dollar	US$	1.0	1.0	1.0	1.0	1.0
Nauru	Australian dollar	A$	1.4	1.3	1.3	1.2	1.2
Palau, Rep. of	US dollar	US$	1.0	1.0	1.0	1.0	1.0
Papua New Guinea	Kina	K	3.2	3.1	3.1	3.0	2.7
Samoa	Tala	ST	2.8	2.7	2.8	2.6	2.6
Solomon Islands	Sol. Islands dollar	SI$	7.5	7.5	7.6	7.7	7.7
Timor-Leste, Dem. Rep. of	US dollar	US$	1.0	1.0	1.0	1.0	1.0
Tonga	Pa'anga	T$	2.0	1.9	2.0	2.0	1.9
Tuvalu	Australian dollar	A$	1.4	1.3	1.3	1.2	1.2
Vanuatu	Vatu	Vt	111.9	109.2	110.5	103.2	96.9

- = not available.

Table A20 Gross international reserves (US$ million)

	2004	2005	2006	2007	2008
Central Asia					
Armenia	548	669	1,072	1,657	1,405
Azerbaijan	1,075	1,178	2,500	4,273	6,467
Georgia	387	479	931	1,361	1,480
Kazakhstan	9,277	7,070	19,126	17,629	19,401
Kyrgyz Republic	565	612	817	1,177	1,225
Tajikistan	189	91	111	107	169
Turkmenistan	2,729	4,457	8,059	13,222	-
Uzbekistan	2,146	2,895	4,459	7,413	10,145
East Asia					
China, People's Rep. of	614,500	821,514	1,068,490	1,540,000	1,980,000
Hong Kong, China	123,569	124,278	133,204	152,693	182,539
Korea, Rep. of	199,066	210,391	238,956	262,224	201,223
Mongolia	208	333	718	972	657
Taipei,China	241,738	253,290	266,148	270,311	291,707
South Asia					
Afghanistan, Islamic Rep. of	1,283	1,662	2,040	2,784	3,104
Bangladesh	2,705	2,930	3,484	5,077	6,149
Bhutan	383	367	479	600	646
India	141,514	151,622	199,179	309,723	-
Maldives	204	187	232	309	241
Nepal	1,465	1,493	1,789	1,999	2,477
Pakistan	10,554	9,791	10,760	13,345	8,577
Sri Lanka	2,196	2,735	2,837	3,508	1,753
Southeast Asia					
Brunei Darussalam	505	494	523	610	650
Cambodia	809	915	1,097	1,616	2,292
Indonesia	36,321	34,724	42,586	56,920	51,639
Lao People's Dem. Rep.	223	234	327	535	622
Malaysia	66,241	70,175	82,237	101,517	89,756
Myanmar	873	1,026	2,503	3,638	-
Philippines	16,228	18,494	22,967	33,751	37,551
Singapore	112,575	116,173	136,261	162,957	174,196
Thailand	49,832	52,066	66,985	87,455	111,008
Viet Nam	6,314	8,557	11,483	21,000	23,000
The Pacific					
Cook Islands	-	-	-	-	-
Fiji Islands	667	520	520	618	431
Kiribati	605	592	-	-	-
Marshall Islands, Rep. of	11	5	5	-	-
Micronesia, Fed. States of	55	50	47	50	45
Nauru	-	-	-	-	-
Palau, Rep. of	-	-	-	-	-
Papua New Guinea	643	763	1,415	2,109	2,093
Samoa	72	75	74	90	82
Solomon Islands	80	96	102	118	-
Timor-Leste, Dem. Rep. of	196	524	-72	146	-
Tonga	44	42	41	46	47
Tuvalu	-	-	-	-	-
Vanuatu	46	69	102	121	146

- = not available.

Table A21 Central government expenditures (% of GDP)

	2004	2005	2006	2007	2008
Central Asia					
Armenia	17.5	18.6	18.1	20.2	22.2
Azerbaijan	17.6	17.1	20.2	21.4	29.1
Georgia	18.9	24.9	29.7	34.0	35.9
Kazakhstan	22.1	27.0	22.1	24.1	27.5
Kyrgyz Republic	27.5	28.1	28.9	31.0	33.1
Tajikistan	20.3	23.0	21.9	27.8	28.5
Turkmenistan	18.9	19.6	15.5	13.3	15.7
Uzbekistan	32.3	32.5	30.9	30.2	30.8
East Asia					
China, People's Rep. of	17.8	18.5	19.1	19.3	20.8
Hong Kong, China	18.7	16.9	15.5	14.5	18.9
Korea, Rep. of	22.3	23.2	24.3	23.3	24.4
Mongolia	35.0	27.5	33.3	38.0	40.2
Taipei,China	20.2	19.9	18.7	18.2	20.6
South Asia					
Afghanistan, Islamic Rep. of	13.9	16.6	19.6	19.9	20.6
Bangladesh	13.3	13.8	13.9	13.4	15.9
Bhutan	34.1	37.5	35.8	34.3	41.0
India	27.1	26.5	27.4	27.7	-
Maldives	36.0	59.0	59.3	66.1	67.0
Nepal	14.3	14.9	14.5	15.9	17.6
Pakistan	16.9	17.2	18.4	19.2	21.7
Sri Lanka	22.8	23.8	24.3	23.5	22.4
Southeast Asia					
Brunei Darussalam	36.6	32.5	31.7	32.5	27.8
Cambodia	14.4	12.8	14.2	14.7	14.6
Indonesia	18.7	18.4	20.1	19.2	19.9
Lao People's Dem. Rep.	15.1	18.2	17.0	18.5	20.5
Malaysia	25.1	23.9	24.9	25.0	26.5
Myanmar	-	-	-	-	-
Philippines	18.3	17.7	17.3	17.3	17.0
Singapore	13.9	13.1	13.8	14.7	17.5
Thailand	17.5	17.6	17.7	18.3	17.3
Viet Nam	29.1	32.1	30.9	33.1	31.7
The Pacific					
Cook Islands	31.0	33.0	35.4	38.2	41.8
Fiji Islands	33.0	34.5	28.4	27.4	26.0
Kiribati	140.9	149.0	136.6	-	-
Marshall Islands, Rep. of	58.8	64.0	64.3	64.0	-
Micronesia, Fed. States of	75.6	63.8	65.4	64.9	62.8
Nauru	-	56.8	92.8	82.9	125.2
Palau, Rep. of	60.0	52.6	58.4	57.3	49.6
Papua New Guinea	32.8	35.0	33.7	35.0	36.1
Samoa	31.1	35.2	31.3	34.3	33.3
Solomon Islands	21.2	24.4	22.3	24.5	-
Timor-Leste, Dem. Rep. of	76.7	75.1	62.1	90.8	145.9
Tonga	30.1	28.2	37.4	32.7	31.3
Tuvalu	85.6	92.4	73.7	74.3	118.9
Vanuatu	20.9	19.7	20.9	23.4	19.4

- = not available.

Table A22 Central government revenues (% of GDP)

	2004	2005	2006	2007	2008
Central Asia					
Armenia	15.8	16.7	16.6	18.7	21.6
Azerbaijan	17.7	16.4	20.6	21.2	27.4
Georgia	22.0	23.4	26.7	29.3	30.2
Kazakhstan	21.9	27.6	22.9	22.5	25.4
Kyrgyz Republic	23.1	24.7	26.4	30.2	31.2
Tajikistan	17.9	20.1	23.6	21.6	21.4
Turkmenistan	19.3	20.4	21.0	17.2	20.0
Uzbekistan	32.9	33.8	33.1	32.3	32.8
East Asia					
China, People's Rep. of	16.5	17.3	18.3	19.9	20.4
Hong Kong, China	20.4	17.9	19.5	22.2	18.6
Korea, Rep. of	20.0	20.5	24.7	23.7	22.7
Mongolia	33.1	30.1	36.6	40.9	35.2
Taipei,China	17.8	18.3	18.1	17.8	18.3
South Asia					
Afghanistan, Islamic Rep. of	12.7	17.6	16.8	18.1	16.5
Bangladesh	10.1	10.5	10.7	10.2	11.2
Bhutan	36.0	30.5	35.0	35.0	37.8
India	19.7	19.8	21.1	22.2	-
Maldives	34.5	48.1	52.5	58.2	51.3
Nepal	13.4	14.1	12.9	14.1	15.6
Pakistan	14.1	13.8	14.1	14.9	14.3
Sri Lanka	14.9	15.5	16.3	15.8	15.6
Southeast Asia					
Brunei Darussalam	48.1	53.5	51.1	54.2	63.9
Cambodia	10.3	10.3	11.5	11.9	12.5
Indonesia	17.6	17.9	19.1	17.9	19.8
Lao People's Dem. Rep.	11.4	11.9	12.9	14.0	14.7
Malaysia	21.0	20.3	21.5	21.8	21.8
Myanmar	-	-	-	-	-
Philippines	14.5	15.0	16.2	17.1	16.0
Singapore	20.8	22.0	22.0	24.3	23.2
Thailand	17.8	17.7	17.4	17.3	16.9
Viet Nam	27.8	28.4	29.7	27.6	27.0
The Pacific					
Cook Islands	34.3	37.0	38.0	38.3	40.9
Fiji Islands	24.9	24.2	25.6	25.6	24.5
Kiribati	123.9	146.2	130.9	-	-
Marshall Islands, Rep. of	57.4	61.4	65.2	63.3	-
Micronesia, Fed. States of	59.6	58.6	58.9	61.6	60.0
Nauru	-	28.6	56.6	87.7	125.8
Palau, Rep. of	53.0	51.8	52.5	52.5	44.8
Papua New Guinea	34.4	35.1	36.8	37.6	36.1
Samoa	30.3	35.5	31.0	35.4	30.1
Solomon Islands	25.3	25.0	22.9	24.3	-
Timor-Leste, Dem. Rep. of	87.1	113.1	193.0	355.1	397.7
Tonga	28.1	29.0	33.1	34.1	33.3
Tuvalu	70.9	85.0	92.5	60.0	113.4
Vanuatu	22.1	21.8	21.8	23.5	25.7

- = not available.

Table A23 Fiscal balance of central government (% of GDP)

	2004	2005	2006	2007	2008
Central Asia					
Armenia	-1.7	-1.9	-1.5	-1.5	-0.6
Azerbaijan	0.1	-0.7	0.4	-0.2	-1.7
Georgia	3.2	-1.5	-3.0	-4.7	-5.7
Kazakhstan	-0.2	0.6	0.8	-1.7	-2.1
Kyrgyz Republic	-4.5	-3.4	-2.5	-0.8	-1.9
Tajikistan	-2.4	-2.9	1.7	-6.2	-7.2
Turkmenistan	0.4	0.8	5.5	3.9	4.3
Uzbekistan	0.6	1.3	2.2	2.1	2.0
East Asia					
China, People's Rep. of	-1.3	-1.2	-0.8	0.6	-0.4
Hong Kong, China	1.7	1.0	4.0	7.7	-0.3
Korea, Rep. of	-2.3	-2.6	0.4	0.5	-1.7
Mongolia	-1.8	2.6	3.3	2.9	-5.0
Taipei,China	-2.4	-1.6	-0.7	-0.4	-2.3
South Asia					
Afghanistan, Islamic Rep. of	-1.4	1.0	-2.9	-1.8	-4.1
Bangladesh	-3.2	-3.3	-3.2	-3.2	-4.7
Bhutan	1.9	-7.0	-0.8	0.6	-3.2
India	-7.5	-6.7	-6.4	-5.4	-6.0
Maldives	-1.6	-10.9	-6.8	-7.9	-15.7
Nepal	-0.9	-0.8	-1.6	-1.8	-2.0
Pakistan	-2.9	-3.3	-4.3	-4.3	-7.4
Sri Lanka	-7.9	-8.4	-8.0	-7.7	-6.8
Southeast Asia					
Brunei Darussalam	11.5	21.0	19.4	21.7	36.1
Cambodia	-4.1	-2.5	-2.7	-2.9	-2.1
Indonesia	-1.1	-0.5	-1.0	-1.2	-0.1
Lao People's Dem. Rep.	-3.8	-6.3	-4.2	-4.5	-5.8
Malaysia	-4.1	-3.6	-3.3	-3.2	-4.7
Myanmar	-	-	-	-	-
Philippines	-3.8	-2.7	-1.1	-0.2	-0.9
Singapore	6.9	9.0	8.2	9.6	5.7
Thailand	0.3	0.2	0.1	-1.1	-0.3
Viet Nam	-1.3	-3.6	-1.2	-5.5	-4.7
The Pacific					
Cook Islands	3.3	4.0	2.6	0.1	-0.8
Fiji Islands	-8.1	-10.3	-2.9	-1.8	-1.5
Kiribati	-16.9	-2.8	-5.7	-3.4	-13.0
Marshall Islands, Rep. of	-1.3	-2.6	0.9	-0.7	-
Micronesia, Fed. States of	-16.0	-5.3	-6.4	-3.3	-3.0
Nauru	-	-28.3	-36.3	4.8	0.6
Palau, Rep. of	-6.9	-0.8	-5.9	-4.9	-4.8
Papua New Guinea	1.6	0.1	3.1	2.5	0.0
Samoa	-0.8	0.3	-0.4	1.1	-3.2
Solomon Islands	4.1	0.6	0.7	-0.3	-5.6
Timor-Leste, Dem. Rep. of	10.4	38.0	130.9	264.3	251.8
Tonga	-2.0	0.7	-4.3	1.4	2.0
Tuvalu	-14.7	-7.4	18.7	-14.3	-5.4
Vanuatu	1.2	2.1	0.9	0.1	6.3

- = not available.